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THE DOG THAT DIDN'T BARK: PRIVATE INVESTMENT FUNDS AND RELATIONAL CONTRACTS IN THE WAKE OF THE GREAT RECESSION

*Robert C. Illig**

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In the aftermath of the subprime mortgage crisis, the contract rights of numerous hedge funds and venture capital funds were breached. These contracts were complex and sophisticated and had been negotiated at great time and expense. Yet despite all of the assumptions of neo-classical contracts theory, nothing happened. Practically none of these injured parties sued to enforce their rights.

Professor Illig uses this dearth of litigation to conduct a form of natural experiment as to the value of contract law. Discrete market participants contracted before the crash and then pursued their rights in court afterwards, while relational market participants contracted but refrained from suing. Given this bifurcated response to the identical stimulus, Professor Illig queries: why did the relational parties bother to contract in the first place? If they could have predicted the likelihood of their ex post *inertia, then as rational economic actors they must have valued contracting for something other than as insurer of their reasonable expectations. For them, a contract must provide significant symbolic and ceremonial value. Based on this finding—as well as on complementary research from the field of behavioral economics—Professor Illig concludes by arguing against a universalist approach to contract law. Instead, he recommends that contract doctrine be evolved to reflect its dual nature—as insurer of expectations in the context of discrete exchanges and as a source of imagery and ritual in the context of relational affiliations. Doing so would enhance the impact of social norms as a mechanism for avoiding and resolving disputes.*

I. INTRODUCTION

"Is there any point to which you would wish to draw my attention?"
"To the curious incident of the dog in the night-time."
"The dog did nothing in the night-time."
"That was the curious incident," remarked Sherlock Holmes.[1]

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1. ARTHUR CONAN DOYLE, *Silver Blaze*, *in* THE MEMOIRS OF SHERLOCK HOLMES 1, 22 (1903).

Looking back, we can say without risk of hyperbole that the subprime mortgage crisis of 2008 constituted the largest single disruption to the American economy since the onset of the Great Depression. It resulted in massive wealth destruction, unemployment for millions, and a worldwide recession that in many ways rivals that of the 1930s.

For legal and other scholars, however, the crash might be viewed more as boon than bane. Its awesome size, its abrupt onset and swift conclusion, and the fact that it was generally unforeseen all combine to create near-ideal circumstances to consider a series of natural experiments. By comparing the behavior of various market players in the aftermath of the turmoil, we can uncover insights about their interests and incentives that lay hidden during more placid times.

One such natural experiment involves the enforcement value of contract rights. We can observe, for example, that countless lawsuits were filed to vindicate the many contract rights that were breached as a result of the economic turmoil. Noticeably absent, however, was significant litigation among the surviving investment banks, pension funds, insurance companies, and other major American financial institutions. For the most part, the financial elite didn't sue one another, though they had ample cause to do so. Their dogs, in other words, didn't bark.

This incongruent behavior is best explained by reference to the pioneering law and sociology work of contracts scholars like Ian Macneil, one of the originators of relational contract theory. These non-suing financial institutions are repeat players in a close-knit market who depend upon long-term, face-to-face relationships with their counterparties in order to prosper. In Macneil's lexicography, the industry we call Wall Street is comprised of a web of "relational contracts."[2]

What Macneil's work fails to address, however, is a deeper question that lies hidden within the rubble of the market collapse. If these relational market participants knew or could have predicted that they would never sue, why did they expend the time and expense of contracting in the first place? In other words, what is the purpose and value of contract law for relational contractors?

Both classical and neo-classical contracts theory assume that the primary value of a contract lies in its enforceability. The answer to "why contract?" has always been the suggestion that contract rights provide a guaranty of one's reasonable expectations.[3] If one's counterparty cannot or will not perform, a court will force it to do so—subject only to the

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2. *See generally* Ian R. Macneil, The New Social Contract: An Inquiry into Modern Contractual Relations (1980).

3. *See* E. Allan Farnsworth, Contracts § 1.3 (4th ed. 2004) ("From the perspective of society as a whole, the function of the law of contracts might have been seen as furthering the general economic good by encouraging parties to enter into . . . productive transactions. From the perspective of the parties themselves, the function might have been viewed more narrowly as aiding them in planning for the future by protecting their expectations.").

limitations imposed by federal bankruptcy law—and thereby assist the aggrieved party to realize the anticipated results of her deal. Written contracts, viewed in this light, serve as a form of governmentally enforced insurance.

In the wake of the crash, however, we see evidence of something far more complex and important taking place. The disinclination of institutional investors to sue one another suggests that they value their long-term relationships with their counterparties more than they value the potential recovery of their short-term losses. But if they never intended to enforce their rights—or if they were sufficiently rational and self-aware as to be able to predict that they would not do so—then their primary purpose for contracting must have been something other than to insure their reasonable expectations.

The purpose of this Article is to focus on why a relational market player might value contract law if not to obtain enforceable contract rights.[4] In this respect, it is in many ways the inverse of the work of Stewart Macaulay, the other great pioneer (along with Macneil) of relational contract theory. For him, the interesting question was why players in certain industries chose not to operate pursuant to formal, written contracts.[5] For me, the question is just the opposite—why contract at all? Indeed, the aftermath of 2008 suggests that for relational contractors opting out may not be the anomalous state. The true oddity, it seems, is that any of them bothered to opt in.

The solution to this conundrum appears to lie in the multiple functions that contract law affords. In addition to having enforcement value, contracts also have value as symbols and sources of ritual. Whether or not a contracting party ever sues to enforce her rights, she benefits from the imprimatur of sophistication and insider status that is provided by the existence of a properly crafted agreement. Likewise, the ceremonial act of negotiating and entering into a contract provides value by helping the parties bond and by highlighting for them their transition from economic strangers to co-adventurers.[6] Thus, many relational market participants may value contracting not solely or even primarily as a guaranty of their reasonable expectations, but as a symbol and a rite of passage. This possibility is supported by parallel findings in behavioral economics.[7]

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4. *See* Mark C. Suchman, *The Contract as Social Artifact*, 37 Law & Soc'y Rev. 91, 97 (2003) (noting that, in most transactions, "legal doctrine is obscure, and the threat of legal enforcement is remote; yet actors often invest substantial resources into producing written contracts.").

5. *See generally* Stewart Macaulay, *Non-Contractual Relations in Business: A Preliminary Study*, 28 Am. Soc. Rev. 55 (1963) (describing the results of in-person interviews with sixty-eight businessmen and lawyers about the value of contract law).

6. *See* Meinhard v. Salmon, 164 N.E. 545, 546 (N.Y. 1928) (Cardozo, J.) (distinguishing long-term business partners, whom he labeled "co-adventurers," from the discrete contractors whom he viewed as comprising "the crowd").

7. *See infra* Part IV.B.

In Part II of this Article, I describe the contours of this particular natural experiment by focusing on two categories of relational contractors—managers and investors of hedge funds and venture capital funds. In doing so, I make two primary factual claims. First, although these parties elected not to sue to enforce their rights, they had cause to do so; they were parties to enforceable contracts that were breached. And second, many non-relational contractors did indeed sue, suggesting that there is a distinction between how relational and discrete market participants perceive the value of contract law. I also make several methodological observations regarding the risks and benefits inherent in this type of research.

In Part III, I describe the value that contract law provides as a source of symbolism and ritual. Ultimately, I conclude that the more relational the parties' affiliation, the more likely they are to privilege the ceremonial and totemic functions of contracting over its traditional role as insurer of expectations.

Finally, in Part IV, I use the results of the natural experiment to re-visit the work of relational contracts scholars. In particular, I question Macneil's desire for a universalist approach that seeks to treat all contracts, relational and otherwise, as being of a kind. Instead, I argue that the results of the experiment, coupled with complementary findings in the field of behavioral economics, yield a different result. Contracts are not all of a universal type and should not be treated as such. Rather, they fall into multiple categories and the law should be tailored to address the particular strengths and weaknesses of each individual contract regime. Doing so would have the added benefit of enhancing the impact of social norms as a mechanism for avoiding and resolving disputes.

II. A Natural Experiment as to the Value of Contract Law

During the months of market turmoil that followed the collapse of Lehman Brothers in September 2008, many large hedge funds refused to honor investor requests to withdraw their money. At the same time, several major financial institutions preemptively refused to contribute the capital they had promised to invest in venture capital funds. In both cases, such actions breached the complex agreements the parties had negotiated. In neither case did any significant number of parties sue.[8]

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8. It is impossible to prove the negative—that absolutely no private investment fund managers or investors sued one another. Indeed, there were several reported cases of litigation, though such reports were isolated and frequently involved unusual circumstances. *See, e.g.*, Susan Pulliam, *Locked In: When Hedge Funds Bar the Door*, Wall St. J., July 2, 2008, at A1, A10, *available at* http://online.wsj.com/article/SB121495893887021511.html. However, the general scarcity of newsworthy reports in a high-profile industry, the lack of results from searches of online databases of court decisions, and conversations with fund managers all suggest that the frequency of actual litigation post-2008 was disproportionately small as compared to the widespread wave of contract breaches that swept through Wall Street and the world of investment funds.

More importantly, for purposes of this Article, I do not seek to prove an absolute absence of litigation. Rather, I only suggest that there was a greater tendency among relational con-

By contrast, during the same period, countless lawsuits were brought by and against now defunct entities like Lehman Brothers as well as against both homeowners and the banks that packaged and sold faulty mortgaged-backed securities, among others. There was also substantial litigation between leveraged buyout funds and their target companies.[9] Thus, lawsuits were common in the wake of the market collapse, just not among an identifiable subset of relational contractors. The result of this disparate behavior is a naturally occurring experiment where two distinct sets of market participants responded differently to similar economic and legal circumstances.

In Part II, I explore the contours of this natural experiment by first examining in-depth the nature of the private investment contracts that were breached but not enforced, and then by comparing them with contracts whose breach was enforced. I conclude that the most likely explanation for the parties' varying responses to the widespread incidence of breach lies in the degree of relationality inherent in their business dealings. Finally, I make several observations about both the benefits and limitations of this type of research methodology.

A. *The Parties*

In the early 1960s, Stewart Macaulay began writing about the non-contractual elements of business relationships. In particular, he suggested that when disputes arise between parties to complex business affiliations, the result is often a resolution that pays little or no heed to the written words of the contract.[10] Under such circumstances, social norms, rather than formalistic contract rights, appear to take precedence. This insight served as the theoretical foundation for subsequent empirical work by scholars like Lisa Bernstein and Robert Ellickson. They explored how market segments operating outside of the legal system—in particular, diamond merchants and cattle ranchers—organized themselves and resolved disputes.[11]

Ian Macneil, while attempting to build on Macaulay's work from a theoretical standpoint, made the crucial observation that contracts can be

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tractors to forego resort to the legal system as a means of resolving their disputes. To the extent such a tendency exists, it is reasonable to surmise that parties who value contracts but not litigation must value contract law for reasons other than its insurance function. *See generally infra* Part III.

9. *See* Steven M. Davidoff, *The Failure of Private Equity*, 82 S. CAL. L. REV. 481, 499-502, 510-11 (2008).

10. Macaulay, *supra* note 5, at 60-61.

11. *See* Avery Katz, *Taking Private Ordering Seriously*, 144 U. PA. L. REV. 1745, 1745 (1996) (citations omitted) ("In applications ranging from Robert Ellickson's seminal work on rancher/farmer relations in Shasta Country, California, to Lisa Bernstein's investigation of extralegal contractual relations among wholesale diamond traders . . . an increasing number of legal and economic scholars have shown how private systems of rules work to regulate economic relations among the communities that adopt them.") .

placed on a continuum depending upon how "relational" they are.[12] On one end of Macneil's spectrum lie one-off, spot transactions in which the parties make discrete exchanges of goods or monies while owing one another little in the way of prior or subsequent duties. On the other end are more complex, longer-term relationships that embody repeated dealings and close social interactions.[13]

On the continuum Macneil describes, the contracts governing the relationships among the nation's major financial institutions—the banks and investment pools that we refer to collectively as "Wall Street"—must be understood as occupying a space near the far end of the relational side.[14] Their dealings are ongoing, face-to-face, and frequent. The survival of any one such institution depends on its ability to interact and trade with each other such institution. To use Macneil's terminology, their myriad of isolated transactions combine and interlace to create "relational patterns."[15]

For purposes of this Article, I will limit the discussion to a particular subset of these relationally oriented financial institutions—private investment funds, a category that includes hedge funds, private equity funds, and venture capital funds, among others. I focus on private investment funds because they are remarkably similar to one another in terms of both formal structure and financing, thereby enabling us to answer Mark Suchman's call for "macroscopic consideration of entire contract regimes."[16]

The structural uniformity among private investment funds results because they function primarily as alternative investment vehicles for a relatively closed set of corporations, endowments, pension funds, foundations and high-net-worth individuals, each of which is constantly inundated with multiple, competing investment opportunities.[17] The fund managers' ability to attract capital therefore arises partly from their ability to differenti-

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12. Ian R. Macneil, *Relational Contract Theory: Challenges and Queries*, 94 Nw. U. L. Rev. 877, 894 (2000) [hereinafter Macneil, *Relational Contract Theory*] ("Probably the most recognized aspect of my work in contract is the use of a spectrum of contractual behavior and norms with poles, labeled relational and discrete, respectively."). For a detailed description and analysis of the spectrum, see Ian R. Macneil, *The Many Futures of Contracts*, 47 S. Cal. L. Rev. 691, 737-805 (1974) [hereinafter Macneil, *The Many Futures of Contracts*].

13. In distinguishing between discrete and relational contracts, Macneil draws on the sociological concepts of primary and non-primary relations, whereby relational contracts fit the model of primary relations, and discrete contracts constitute non-primary relations. *See* Macneil, *The Many Futures of Contracts*, *supra* note 12, at 722. A related concept is Oliver Williamson's distinction between markets and hierarchies. *See generally* Oliver E. Williamson, *Markets and Hierarchies: Some Elementary Considerations,* 63 Am. Econ. Rev. 316 (1973).

14. *See generally* Macneil, *The Many Futures of Contracts, supra* note 12, at 691.

15. Ian R. Macneil, *Values in Contract: Internal and External*, 78 Nw. U. L. Rev. 340, 345 (1983).

16. *See* Suchman, *supra* note 4, at 115 (advocating that additional scholarly attention be devoted to the study of industry-wide contracting schemes).

17. *See* Robert C. Illig, *What Hedge Funds Can Teach Corporate America: A Roadmap for Achieving Institutional Investor Oversight*, 57 Am. U. L. Rev. 225, 279-80 (2008).

ate their particular investment strategy and partly from their ability to claim some minimum level of industry-segment-specific sophistication. By mimicking the essential terms of their competitors' contracts, fund managers are able to identify themselves as industry insiders who are familiar with how the game is played, while simultaneously shifting the focus of attention of their potential clients away from seemingly boring legal niceties and onto the issue of the managers' particular investment prowess. As a result of the managers' need to repeatedly solicit the same sources, generally offering terms on a take-it-or-leave-it basis, a robust and transparent (though exclusive) market has evolved among the fund managers and their investors. The result is uniformity with respect to legal structure coupled with differentiation of investment strategy or prowess.[18]

As a test subject, however, the upside of the industry's overall uniformity would appear to be outweighed by the downside of its secrecy. After all, the specific details of the contracts governing any given private investment fund are generally not public and thus would appear largely unknowable to those outside the particular transaction.[19] Fortunately, this is not the case. Because of ongoing efforts by institutional investors seeking transparency in industry-standard financial arrangements, it is possible for outside observers to generalize regarding fund contracts with a fair amount of confidence. For example, in 1996, a group of nine state retirement and pension funds commissioned a private study of common investment terms.[20] Presumably, the consulting firm that conducted the study had access to a large store of actual fund documents from the sponsoring states when preparing its summaries. Meanwhile, Dow Jones, among others, has followed the consultants' lead and begun publishing periodic surveys of prevailing terms and conditions of private investment fund contracts.[21] The Securities and Exchange Commission also issued an authoritative survey of contract terms, though it was limited in focus to those governing hedge funds.[22]

By reviewing these and other similar publications and online databases, it is possible to consider the industry as a whole, thereby enabling us to generalize across a broad but mostly uniform segment of relational market participants. Furthermore, because surveys are inherently backward-looking, reliance in particular on the 2009 Dow Jones study

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18. *See* Davidoff, *supra* note 9, at 526-35 (arguing that the consistency in private equity deal structures is based largely on path dependency).

19. *See* Sec. & Exch. Comm'n, Implications of the Growth of Hedge Funds, at x (2003) [hereinafter SEC Hedge Fund Report], *available at* http://www.sec.gov/news/studies/hedgefunds0903.pdf (noting that the Commission lacked even the most basic information about the hedge fund industry and how it operates).

20. Key Terms and Conditions for Private Equity Investing 69 (William M. Mercer, Inc., ed. 1996) [hereinafter Mercer Report]. *See also* James M. Schell, Private Equity Funds: Business Structure and Operations § 1.02[1] (2012).

21. *See* Dow Jones, Private Equity Partnership Terms & Conditions 5 (2012) [hereinafter Private Equity Terms & Conditions].

22. *See* SEC Hedge Fund Report, *supra* note 19, at 1-3.

should present an accurate view of market conditions prevailing at the time of the 2008 crash.

B. *The Contracts*

In order to delve more deeply into the question of why relational parties contract, I attempt in Part II.B. to explicate certain key provisions of the contracts entered into between private investment fund managers and their investors prior to the crash of 2008. My point is to demonstrate that these managers and investors were in possession of material and enforceable contract rights circa 2007. The dearth of post-crash litigation, in other words, cannot be explained by the absence of a basis on which to sue.

In terms of overall structure, private investment funds are typically organized as limited partnerships. Wealthy investors contribute the bulk of the monies and serve as passive limited partners, while professional managers form an entity to serve as the general partner and select and administer the funds' investments.[23] The funds themselves lack any real operations but rather serve as pools of cash aggregated for investment purposes.

Within the private investment fund industry, however, there is a fair amount of contractual variation as between funds with different investment styles. In particular, venture capital funds generally enter into contracts that differ in important ways from those of hedge funds. As a result of these differences, it is the venture capital fund investors who appear to have engaged in post-2008 breach, while in the case of hedge funds, it was the managers who were at fault. The complimentary yet contrasting nature of the two sets of funds therefore makes them ideal for comparison. Though their contractual relationships differ in detail, the funds themselves appear to have reacted to the crash in precisely the same manner. The remainder of this Article therefore focuses particularly on venture capital and hedge funds as being representative of the relational contractors who chose not to sue to enforce their post-2008 breach.

Venture Capital Funds. With respect to a typical venture capital fund, the managers' goal is to invest a fixed amount of capital in a relatively small number of early stage or other non-public companies that have significant growth potential over the relatively near term.[24] Their hope, in lay terms, is to uncover a dotcom or biotech company with the prospect of

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23. *See* Private Equity Terms & Conditions, *supra* note 21, at 6-7. One of the most distinctive attributes of private investment fund industry is its famous "two and twenty" formula for compensating fund managers. The prevailing market norm is for them to receive an annual management fee of around two percent, theoretically intended to offset expenses, coupled with a twenty-percent incentive fee, known as a "carried interest," on any profits that exceed a specified benchmark. *Id.* at 28, 36.

24. For a discussion of the definition of venture capital funds, see generally Douglas J. Cumming & Sofia A. Johan, Venture Capital and Private Equity Contracting: An International Perspective 3-7 (2009).

exploding into profitability once it secures sufficient seed or expansion capital—the next Google or Facebook, so to speak.

Because the genius lies in the discovery, a key issue regarding the structure of venture capital funds is the considerable amount of time the managers must expend in searching for appropriate investment targets before any investments are actually made. Indeed, during the typical seven- to ten-year life-cycle of a venture capital fund, it may take several years to fully invest the fund's capital.[25] Venture capital funds may therefore be understood as having two distinct phases—an exploratory period at the beginning of the fund's life, during which time the managers are engaged in identifying appropriate investment targets, and an inactive period at the end of the fund's life, during which the managers wait to see when and if their investments turn profitable.[26]

During the initial exploratory period, before the managers have identified any targets, venture capital funds have no need for significant investor capital. They do, however, have a need from the outset for commitments of capital. Firm commitments allow the managers both to know how much money will be at hand when an appropriate target turns up and to credibly negotiate with its investment targets. Most venture capital funds are therefore structured so that little or no money is contributed until required. Rather, fund contracts require that investors commit to a certain level of investment and then stand ready to inject the promised capital into the fund as and when it is needed.[27] Then, when the managers identify an appropriate target, be it after three months or three years, they make a capital call on the investors, who are permitted a brief amount of time during which to contribute the requested funds (up to the maximum amount of their commitment).[28]

As well as being practical, this promise-now-contribute-later scheme serves to boost the reported performance of the fund. Were the managers to accept contributions prior to identifying attractive targets of opportunity, they would be unable to put that capital to its best use. Instead, they would have no choice but to temporarily park the excess currency in some sort of safe and liquid—and hence low-interest—investment vehicle.[29]

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25. *See id*. at 5. Many funds have requirements that if the money is not invested within five years, any unused capital commitments must be released and the commitment canceled. *See* PRIVATE EQUITY TERMS & CONDITIONS, *supra* note 21, at 14 (reporting that 81% of venture capital funds surveyed have an investment period of five or fewer years).

26. *See* PAUL GOMPERS & JOSH LERNER, THE VENTURE CAPITAL CYCLE 39-40 (4th ed. 2000). Indeed, it is common during these relatively less-busy later years for the fund managers to commence a new fund, such that the exploratory and wait-and-see periods for the two funds overlap. PRIVATE EQUITY TERMS & CONDITIONS, *supra* note 21, at 24 (reporting that many fund contracts require that the managers invest between two-thirds and three-fourths of their committed capital before being permitted to begin fundraising for a follow-on fund).

27. PRIVATE EQUITY TERMS & CONDITIONS, *supra* note 21, at 23-24.

28. *Id*.

29. *Id.*

This would both lengthen the period during which the managers are responsible for providing income growth, and lower the fund's overall return (due to the inclusion of results from low-growth, pre-investment periods). The consequence would be an artificially low return on capital, the principal measure by which the success of a venture capital fund is assessed.[30] Thus, it isn't merely the case that venture capital fund managers don't *need* up-front capital—the fact is that they don't *want* it.

From the standpoint of the attorneys who structure the investment contract, this system of delayed contribution creates an obvious risk. When the time comes to call the capital, investors may be unable or unwilling to contribute the contractually agreed-upon monies, thereby putting the entire fund at risk.[31] To obviate this possibility, lawyers have devised a series of measures that make non-compliance painful.[32] In fact, in order to aid in this effort, the Delaware partnership law specifically provides an exception from the common law rule that contract remedies cannot be punitive.[33] In the case of a party's failure to honor its capital commitments, the contracts *can* be punitive—and they generally are. One common remedy, for example, is the ability of a fund to redeem a non-performing investor's remaining interest at a fraction of its value.[34] The contracts also typically omit traditional "outs" intended to soften the risk of future downturns, such as material adverse change clauses—provisions that allow a party to withdraw from a pending deal upon the occurrence of significant changes in the economy or other "acts of God." Moreover, all of these provisions are lengthy and detailed, and are drafted broadly so as to be as ironclad as possible.

For the purposes of this Article, we therefore find in place prior to 2008 a set of detailed and largely uniform venture capital investment contracts that combine periodic capital calls with stiff penalties for those who do not honor their promised commitment. The stage would seem to be set for a massive round of post-Lehman Brothers litigation over failures by investors to answer capital calls.

Hedge Funds. Hedge funds, by contrast, face a different set of investor-related challenges. Unlike venture capital funds, they do not engage in a single investment strategy.[35] Instead, what unites them as a category

30. Mercer Report, *supra* note 20, at 11.

31. *See* Private Equity Terms & Conditions, *supra* note 21, at 50.

32. *Id.* at 50-51 ("Often, the remedies are intentionally harsh to discourage the possibility of default to the fullest extent possible . . . .").

33. Del. Code Ann. tit. 6, § 17-502(c) (2010) ("A partnership agreement may provide that the interest of any partner who fails to make any contribution that he or she is obligated to make shall be subject to specified penalties for, or specified consequences of, such failure."); Schell, *supra* note 20, at § 9.04[4].

34. Private Equity Terms & Conditions, *supra* note 21, at 50-51.

35. *See* SEC Hedge Fund Report, *supra* note 19, at viii ("Hedge funds utilize a number of different investment styles and strategies and invest in a wide variety of financial instruments. Hedge funds invest in equity and fixed income securities, currencies, over-the-counter derivatives, futures contracts and other assets.").

(aside from their uniform structure) is that they generally make investments that are relatively liquid and hence comparatively easy to exit.[36] Again, in lay terms, they represent the day traders of the institutional investor world. Thus, to the extent that a hedge fund is able to quickly enter and exit investment opportunities, it faces little risk when its pool of available capital grows or shrinks. It simply adjusts the size of its positions to conform to its new level of resources. As a result, such funds can operate in a manner not unlike that of a traditional bank account or money market fund, with an investor being theoretically free to make additional contributions, or withdraw some or all of her earnings and prior contributions, at almost any time.

In this respect, the primary risk for hedge funds vis-à-vis their investors is that the investors will seek to redeem their interests *en masse*, overly frequently, or at inopportune times, such as during a temporary market downturn. To deal with this risk, most hedge funds include an initial lock-up period of one or two years during which no redemptions may be made.[37] Thereafter, redemptions are generally allowed only on fixed, quarterly dates, and even then only upon reasonable advance notice.[38] Withdrawals are thus permitted but in a regulated manner so as to be smooth and predictable. In fact, the structure of most hedge funds is such that the real liquidity risk relating to the availability of funds is borne by the investors. After all, it is the fund managers who control the cash, and like anyone with a bird in the hand, they can always refuse to return it.

Adding to this risk for investors is the increased prevalence among hedge funds of additional limits on withdrawal known as "gates." Gates are a relatively recent form of contractual provision that appear to come in two forms. One allows the fund to limit the percentage that any investor can redeem on any given redemption date. If the fund has a twenty-percent gate, for example, no single investor is permitted to redeem more than twenty percent of her capital at any one time.[39] The other, more

36. Examples of common strategies include directional investing, event-driven investing, and various forms of price-discrepancy arbitrage. *Id.* at 33-36.

37. In fact, the once-traditional one-year lock-up was extended by many funds in the face of regulation promulgated by the Securities and Exchange Commission in 2004 that applied only to funds that permitted withdrawals within their first two years of operation. *See* Illig, *supra* note 17, at 279 n.239. Such regulation was struck down in 2006 by the U.S. Court of Appeals for the District of Columbia Circuit, but initial lock-ups lasting more than one year remain fairly common. *See* Goldstein v. Sec. & Exch. Comm'n, 451 F.3d 873, 877-78, 880 (D.C. Cir. 2006) (holding that the SEC lacked authority to change the definition of the term "adviser" when the definition was contained in a federal statute).

38. This is usually somewhere between thirty and ninety days, depending upon the fund's particular investment strategy and its bargaining power vis-à-vis its investors. *See* SEC Hedge Fund Report, *supra* note 19, at ix.

39. *See* Jonathan Bevilacqua, Comment, *Convergence and Divergence: Blurring the Lines Between Hedge Funds and Private Equity Funds*, 54 Buff. L. Rev., 251, 263-64 (2006).

severe form entitles fund managers to temporarily prohibit all redemptions under a given set of theoretically infrequent circumstances.[40]

Notably for purposes of this Article, however, gates appear to be used mostly by the subset of hedge funds that mimic the illiquid investment strategies most often associated with leveraged buyout funds.[41] Thus, although the existence of gates might insulate a small number of non-traditional hedge funds from accusations that their refusal to return investor capital resulted in a contract breach, most traditional hedge funds that prohibit withdrawals do so in violation of their contractual commitments.[42]

We therefore see a pre-2008 landscape where the majority of hedge funds hold their investors' monies subject to explicit contractual rights of withdrawal. Should they decline to honor such requests, perhaps in order to protect their capital during a crisis like that occurring in the months following the collapse of Lehman Brothers, these hedge funds would appear to be in breach of their written contracts. Again, as was the case among venture capital funds, the stage seems set for significant crash-related litigation.

C. *The Breaches*

Having now attained an understanding of the contractual relations that predominated among private investment fund managers and their investors circa 2007, it is possible to study more closely the circumstances that led to their apparent breach in 2008. Our goal is to uncover the particular nature of the breaches and the responses of the injured parties.

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40. *See* Schell, *supra* note 20, § 1.05[7]. Note that there is an internal logic to this type of flexibility that is rooted in the managers' fiduciary duties to all investors. For example, many hedge funds make bets that securities markets tend to correct themselves, but such corrections can take time to occur. Indeed, the market not infrequently moves in the opposite direction—toward increased irrationality—before eventually correcting itself. *See, e.g.*, Azam Ahmed, *The Hunch, the Pounce and the Kill*, N.Y. Times, May 27, 2012, at BU1. As a result, this investment strategy requires patience and liquidity in order to be successful. Were a minority of investors to request that a material amount of their capital be returned during a period while markets were moving in the wrong direction, the result could be to force the fund to liquidate their bet at the very worst moment, thereby creating losses for all investors. The manager's ability to temporarily suspend redemptions can therefore be seen as a safety valve that allows them to protect non-redeeming limited partners from the effects of panicked selling. Interview with Jamie Hague, Vice President, Millburn Ridgefield Corporation (Aug. 10, 2010) (notes on file with the author).

41. *See* Stephanie Breslow & Paul S Gutman, *Hedge Fund Investment in Private Equity*, PLC Cross-border Private Equity Handbook 9, 12 (June 2005), *http://www.srz.com/files/News/dbe15ae1-db3c-4b9a-95ea-7c5d55d5024b/Presentation/NewsAttachment/c0377368-c9d2-4b70-9241-1c4d9b886749/filesfilesARTICLE-PrivateEquity2005-06—HedgeFundInvestmentInPrivateEquity.pdf*; Bevilacqua, *supra* note 39, at 253 ("In some cases, hedge fund advisers are incorporating 'side pockets,' 'gates,' and 'lock-ups' to the funds that they manage. These fund terms facilitate illiquid investing, but blur the lines between the previously well-defined structures of private equity funds and hedge funds.").

42. *See* Gregory Zuckerman, *Hedge-Fund Investor Goal: An Exit Plan*, Wall St. J., Sept. 9, 2009, at C1.

During the fall of 2008, in the months following the collapse of Lehman Brothers, private investment funds came under attack. Contemporary news reports of the crisis followed a domino-like pattern, with the collapse of Bear Stearns, IndyMac Bancorp, Fannie Mae, Freddie Mac, Lehman Brothers, AIG, Washington Mutual, Wachovia, and others following one after another in rapid but staccato succession.[43] This atmosphere of uncertainty created for investors a very immediate feeling of foreboding. According to one senior banker at JPMorgan, "It was like watching popcorn . . . . You didn't know where it would pop next."[44]

For a time, it was popular to imagine that the next shoe to fall was the supposedly imminent collapse of the private investment fund industry.[45] The problem was not that private investment funds were to blame for the panic, nor that their balance sheets made them more likely to fail than other financial institutions. Indeed, many prominent funds had bet *against* the housing market and were poised to realize huge *gains* as a result of the collapse of subprime mortgages.[46] Rather, the broader concern lay in the fact that the funds' investors were themselves being squeezed, in many cases from multiple directions at once.

First, many highly leveraged institutional investors had made unfortunate bets on the direction of the mortgage industry and needed cash to shore up their balance sheets in the face of growing losses.[47] Thus, even if they would have preferred to hold on to their private investment fund shares, their holdings in hedge funds in particular represented a relatively liquid asset that could theoretically be monetized at a time when nearly all

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43. *See generally* Andrew Ross Sorkin, Too Big to Fail: The Inside Story of How Wall Street and Washington Fought to Save the Financial System—And Themselves (2009).

44. Roger Lowenstein, The End of Wall Street 98 (2010) (quoting an unnamed source).

45. As an interesting side story, it is worth noting that the financial press largely called this one wrong. As September 30th approached—a common day for hedge funds to permit quarterly redemptions—many commentators wondered aloud whether the market would be hit by a sudden outflow of money from private investment funds. *See, e.g.*, Louise Story, *Hedge Funds Are Bracing for Investors to Cash Out*, N.Y. Times, Sept. 29, 2008, at C1. In fact, because most funds require thirty or more days' notice for a redemption, and because the collapse of Lehman Brothers had occurred inside of the applicable thirty-day window leading up to September 30th, this date did not represent a systemic gut-check on the health and future of private investment funds. Indeed, the entire market segment may have benefitted from the luck of timing—the funds' relative illiquidity for periods of less than ninety days appears to have left many hedge funds largely intact during the worst days of the panic.

46. *See generally* Michael Lewis, The Big Short: Inside the Doomsday Machine (2010).

47. *See, e.g.*, Daniel Golden, *Cash Me If You Can*, Upstart Business Journal (Mar. 18 2009), http://upstart.bizjournals.com/executives/2009/03/18/David-Swensen-and-the-Yale-Model.html; Saijel Kishan, *Blue Mountain Freezes $3.1 Billon Credit Hedge Fund (Update1)*, Bloomberg.com (Nov. 3, 2008, 5:15 PM), http://www.bloomberg.com/apps/news?pid=20601087&sid=aKeoPtrg6NbU&refer=home (noting that the fund—which had "outperformed the industry average by almost 10-fold this year"—was nevertheless deluged with redemption requests due to "liquidity pressures" impacting the limited partners).

of Wall Street was scrambling for cash. Whether these investments held the promise of a long-term profit or loss, they represented a short-term source of much-needed liquidity.

Second, because of accumulating losses in other portions of investors' portfolios, the relative size of their private investment fund allocations had grown as compared to their other holdings. Because the value of, say, stocks and real estate was falling faster than the reported value of private investment funds, the mix of securities held by many institutional investors had shifted toward a higher proportion of such alternative investments. This phenomenon is known within the industry as the "denominator effect."[48] In order to maintain their prior mix of investments, and thus remain in compliance with an amalgam of regulatory requirements and internal policies mandating a particular mix, many institutional investors needed to reduce their private investment fund commitments for the very reason that such investments were accruing value (and hence growing in size) as compared to the rest of their portfolio.[49] They had to sell their private investment fund shares, in other words, not because the shares were losers but because, as compared to many other investments, they were winners.

Finally, many investors in venture capital funds had followed a strategy of purposefully over-committing themselves by promising to contribute more money than they had available. Their assumption in doing so was that, because the money would not be needed until an appropriate target investment was identified sometime in the future, they could answer capital calls in a cyclical fashion using the profits they earned from prior investments to fund subsequent requests for cash.[50] Thus, for example, Duke University's endowment found itself underwater in 2008 with respect to its venture capital investments because it had not set aside enough money to meet future capital calls. Rather, it had assumed that there was no need to set aside any savings because its older venture capital investments were likely to mature ahead of schedule and so provide the liquidity needed to fund subsequent capital calls issued by a second generation of

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48. *See* Jonathan Keehner & Jason Kelly, *Harvard-Led Sale of Private-Equity Stakes Hits Values*, BLOOMBERG.COM (Dec. 1, 2008), http://www.bloomberg.com/apps/news?pid=20601109&sid=azBqn85aRXE ("When the value of [liquid] holdings (the denominator) is lower, the percentage of the overall pool devoted to private equity (the numerator) rises, pushing the percentage of illiquid asset classes like private equity too high.").

49. Sarah Lacy, *College Endowments Deserting Venture Capital*, BUSINESSWEEK, Nov. 24, 2008, at 32, *available at* http://www.businessweek.com/stories/2008-11-21/college-endowments-deserting-venture-capitalbusinessweek-business-news-stock-market-and-financial-advice (noting that university endowments at Harvard, Yale, Princeton, Columbia and Duke were all being forced to reduce their exposure to venture capital because of "strict allocation models that dictate how much of an investment portfolio goes to what asset class."); Keehner & Kelly, *supra* note 48. *See also* SEC HEDGE FUND REPORT, *supra* note 19, at 4-5 (describing the market benefits of including hedge fund securities as part of a larger portfolio of investments).

50. *Cash-Poor LPs Face Capital-Call Pressure*, HEDGE FUND ALERT (Nov. 5, 2008), *http://www.hfalert.com/headlines.php?exact=1&hid=138041&s=*.

funds.[51] As the panic played out, however, many older funds found it unwise or impossible to pay out profits at the same rate as in the past—they simply weren't making enough money—while many newer funds called their capital earlier than expected.[52]

The result of this industry-wide capital squeeze, as it pertains to our present inquiry, was twofold. In the case of venture capital funds, the cream of the crop of the nation's institutional investors began to rebuff attempts by fund managers to call their committed capital.[53] These included not only prominent university endowments, such as those at Harvard, Brown, Duke, Stanford, Chicago and UVA, but also well-known private foundations such as the Carnegie Foundation.[54] Even large pension funds like CalPERS, the colossal $200 billion California public pension plan that stands astride the industry, reneged on some of its commitments.[55]

In many cases, these cash-strapped investors proactively informed their fund managers that they should not risk making upcoming capital calls because CalPERS *et al.* would refuse to honor them.[56] Understood as an anticipatory repudiation of their contract obligations, such communications appeared to trigger preexisting enforcement clauses and give the fund managers an immediate claim for total breach of contract.[57] Rather than sue, however, most of the fund managers chose instead to defer making any further capital calls until some unknown date in the future when their investors once again had monies to contribute. The result of this restraint was to spare investors the embarrassment of having to formally renege on their commitments.

Meanwhile, with respect to hedge funds, many fund managers in 2008 and 2009 instituted involuntary lock-up periods and refused to honor the many redemption requests with which they were inundated.[58] It was as if

51. *Duke Shredding Fund Stake to Raise Cash*, HEDGE FUND ALERT (Oct. 29, 2008), http://www.hfalert.com/headlines.php?exact=1&hid=137918&s=duke+shedding.

52. *Id.*

53. In a related development, some large investors attempted to sell their limited partnership interests in the highly illiquid secondary market. *See, e.g.,* Nathan Vardi, *Did Harvard Sell at the Bottom?*, FORBES.COM (Oct. 26, 2009), http://www.forbes.com/2009/10/24/harvard-university-endowment-business-wall-street-harvard.html. Generally, to do so would have required the consent of the funds' managers. *See* SCHELL, *supra* note 20, § 1.03[7].

54. *Cash-Poor LPs Face Capital-Call Pressure, supra* note 50.

55. Christopher Witkowsky, *CalPERS: "Discussing" Capital Call Timings with GPs "Not Unusual,"* PRIVATE EQUITY INTERNATIONAL (Nov. 21, 2008, 10:02 AM), http://www.privateequityonline.com/Article.aspx?article=32420&hashID=F21794BB0D008603E09E1CD728C76BB6C1584742.

56. *Id*.

57. FARNSWORTH, *supra* note 3, § 8.20, at 583 ("With the notable exception of Massachusetts, courts have accepted the general rule that an anticipatory repudiation gives the injured party an immediate claim to damages for total breach, in addition to discharging that party's remaining duties of performance.") (citations omitted).

58. *See, e.g.*, Matthew Goldstein, *Hedge Funds Frozen Shut*, BUSINESSWEEK, Mar. 5, 2008, at 25, *available at* http://www.businessweek.com/stories/2008-03-04/hedge-funds-frozen-

the hedge funds had become Depression-era banks experiencing a run. In response, they closed their doors and declared themselves a holiday. Redemptions would be honored—assuming the market recovered and the losses eventually recouped—but not in the near term.[59] Comparatively liquid investments in hedge funds had suddenly become illiquid and uncertain.

Admittedly, a small minority of these hedge-fund lock-ups appear to have been permitted, or in some cases mandated, by the terms of the investment contracts' gating provisions. Most, however, were made without clear contractual authority.[60] Moreover, where hedge funds were relying on previously negotiated gates, many contemporary industry observers believed that such reliance was unfounded and that the true purpose of the gates was being subverted during a time of crisis.[61] They claimed that, by retaining investors' money, the fund managers were able to continue charging hefty management fees at a time when most financial players were finding profits elusive.[62] Both the curbs on redemption and the use of gates therefore appear to have been in violation of at least the spirit, and in many cases the letter, of the parties' contractual language.

What we find, then, in the wake of the subprime mortgage meltdown, was a situation where large numbers of venture capital fund managers and hedge fund investors had cause to enforce their carefully crafted but

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shut (reporting that at least twenty-four hedge funds had barred limited partners from withdrawing their investments during the period November 2007 to March 2008); Katherine Burton, *Deephaven Freezes Multistrategy Hedge Fund to Avoid Asset Sales*, BLOOMBERG.COM (Oct. 31, 2008, 12:01 AM), http://www.bloomberg.com/apps/news?pid=newsarchive&sid=amUk8rPKk9VU&dbk; Robert Wenzel, *Nobel Prize Winner Scholes Freezes His Hedge Fund After Losses*, ECONOMICPOLICYJOURNAL.COM (Nov. 21, 2008), http://www.economicpolicyjournal.com/2008/11/nobel-prize-winner-scholes-freezes-his.html. The redemption squeeze also worked its way up to the various funds of funds that are themselves investment pools that purchase shares in traditional private investment funds. Christine Williamson, *Liquidity Problems Are Slowing Redemptions*, PENSIONS AND INVESTMENTS, Oct. 5, 2009, at 1.

59. Meanwhile, funds like Ritchie Capital, which had seen its assets plunge from almost $4 billion to around $2 billon, took a middle ground and asked investors to vote on a plan to modify their existing contracts and permit the fund to enact *ex post* a three-year gate. Pulliam, *supra* note 8, at A10. Given the alternative—massive losses and a complete shuttering of the fund—it is not surprising that investors approved the plan. *Id.* at A10.

60. Zuckerman, *supra* note 42, at C1-C2. *See also* Alistair Barr, *Ore Hill Redeems Itself with Man Group's Help*, MARKETWATCH, (June 9, 2010, 11:08 AM), http://www.marketwatch.com/story/ore-hill-redeems-itself-with-man-groups-help-2010-06-09 ("While [the imposition of lock-ups] prevented forced selling at the bottom of the market, some investors vowed never again to put money with the managers involved.").

61. Gregory Zuckerman, *Hedge Funds Make It Hard to Say Goodbye*, WALL ST. J., Apr. 10, 2008, at D1, *available at* http://online.wsj.com/article/SB120779146932503651.html (reporting on several billion-dollar hedge funds that restricted redemptions in March).

62. Alistair Barr, *Hedge Funds Try to Hold Back Redemption Wave*, MARKETWATCH (Nov. 28, 2008), http://www.marketwatch.com/story/hedge-funds-try-to-hold-back-wave-of-investor-redemptions?pagenumber=1 (citing anonymous industry insiders as observing that "managers of these funds may be locking up investors' money so they can keep collecting fees to run their businesses . . . . Without longer lockups, managers would have to sell all the assets and shut down.").

breached contracts. For the most part, however, they opted not to. The dog didn't bark.

D. *The Control Group*

In marked contrast to the absence of lawsuits among relational contractors, the market for discrete contractors in the years following the collapse of Lehman Brothers has been rife with litigation. The most obvious evidence for this is the large number of foreclosures that were (and continue to be) instigated against homeowners who defaulted on their mortgages.[63] Certainly, we witness no hesitation on the part of banks to resort to legal action in the face of widespread breach. And while the typical American mortgage often lasts as long as thirty-years, giving it the superficial appearance of relationality, such a contract stands much closer to the discrete end of Macneil's spectrum. Once the loan documents are signed, the ongoing relationship involves little more than a homeowner's forwarding of a monthly check to a faceless post office box. Indeed, it is practically the norm in the twenty-first century for the originator of the loan to promptly sell it upstream for packaging into some form of securitized (and thus anonymous) debt obligation.[64] Many observers blame the entire subprime crisis on the degree to which personalized mortgage lending has been replaced by an economy of discrete transactors.[65]

Another area of frequent litigation involved investors who had purchased securitized home mortgages in the belief that they represented secure assets only to see their value plummet in the face of the slowdown in home prices.[66] Similar litigation also took place among investors in money market funds who found that their supposedly super-safe investments were not as safe as they had believed.[67] And finally, of course, Bernie Madoff's massive Ponzi scheme, once it was discovered, led inevitably to a massive tangle of litigation.[68] In each of these three cases, the

63. *See, e.g.*, Jim Wilson, *Foreclosures (2012 Robosigning and Mortgage Servicing Settlement)*, N.Y. Times, http://topics.nytimes.com/top/reference/timestopics/subjects/f/foreclosures/index.html (last updated Apr. 2, 2012) ("All told, roughly four million families lost their homes to foreclosure between the beginning of 2007 and early 2012.").

64. Raymond H. Brescia, *Capital in Chaos: The Subprime Mortgage Crisis and the Social Capital Response,* 56 Clev. St. L. Rev. 271, 289-91 (2008).

65. *See, e.g.*, *id.* at 295 ("Instead of the traditional relationship, which involved a borrower and a federally regulated lending institution, the new borrower and lender relationship is often mediated by a mortgage broker with unclear loyalties.").

66. *See, e.g.*, Jonathan D. Glater, *Financial Crisis Provides Fertile Ground for Boom in Lawsuits*, N.Y. Times, Oct. 18, 2008, at B1; Gretchen Morgenson, *Pools That Need Some Sun*, N.Y. Times, Mar. 21, 2010, at BU1.

67. *See, e.g.*, Diana B. Henriques, *Suit Claims Fund Gave a Heads Up*, N.Y. Times, Sept. 23, 2008, at C1.

68. *See, e.g.*, Graham Bowley & Peter Lattman, *1,000's Cases Are Headed for Court as Trustee Seeks Madoff Spoils*, N.Y. Times, Dec. 13, 2010, at B1 ("With the final deadline for litigation having passed at midnight on Saturday, at least 1,000 individual civil lawsuits will now go forward to try to recover more than $50 billion for the victims of the global Ponzi

litigants were either retail investors with no expectation of entering into a long-term relational affiliation with their counter-parties, or an institutional investor that for one or another reasons did not anticipate engaging in future dealings with its former business partners.[69]

Indeed, although much of the non-relational litigation involved retail investors, there are anecdotal instances where large and sophisticated Wall Street institutions resorted to legal action.[70] This occurred only after the nature of their relational attachments was altered, however. The best example of this phenomenon is Lehman Brothers, the firm whose demise most directly gave rise to the crash itself. In the exception that proves the rule, it brought suit against a number of former business partners, including two Wall Street titans, Barclays and JPMorgan Chase, with whom it had numerous, overlapping and long-term business arrangements.[71]

At first glance, Lehman's energetic resort to the legal system might seem to disprove my primary factual claim in that the web of interwoven trades that characterize the dealings between and among banks and investment banks like Lehman Brothers, Barclays and JPMorgan Chase appear to be highly relational.[72] However, the plaintiff in these cases was not Lehman Brothers the Wall Street investment bank with an ongoing interest in protecting its reputation with other major Wall Street players, but a bankrupt Lehman Brothers operating under the protection of a court-sponsored reorganization.[73] As an essentially defunct entity whose primary business activity was to assemble its assets and pay its creditors, Leh-

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scheme orchestrated by Bernard L. Madoff."). *See generally* DIANA B. HENRIQUES, THE WIZARD OF LIES: BERNIE MADOFF AND THE DEATH OF TRUST (2011).

69. *See, e.g.*, Harold Brubaker, *N.J. Suing Lehman Officials: The State, Which Wants to Recoup Pension-Fund Losses Could Not File Against the Defunct Firm*, PHILA. INQUIRER, Mar. 18, 2009, at C1 (bankrupt Lehman Brothers as defendant); Glater, *supra* note 66, at B1; Nelson D. Schwartz & Kevin Roose, *U.S. Sues 17 Mortgage Institutions*, N.Y. TIMES, Sept. 3, 2011, at B1 (US government as plaintiff); Louise Story & Gretchen Morgenson, *A.I.G. Sues Bank of America Over Mortgage Bonds*, N.Y. TIMES, Aug. 8, 2011, at A1 (taxpayer-controlled A.I.G. as plaintiff).

70. *See, e.g., Banks Said to Settle Suit over Mortgage Lender*, N.Y. TIMES, Oct. 10, 2009, at B2.

71. *See* Michael J. de la Merced, *Lehman's Estate Is Suing Barclays Over Unit's Sale*, N.Y. TIMES, Nov. 17, 2009, at B8 (seeking $5 billion in damages); Mike Spector & Susanne Craig, *Lehman Files Suit Versus J.P. Morgan—Bankruptcy Estate Claims Inside Knowledge Used to Make Collateral Calls; Bank Calls It 'Meritless'*, WALL ST. J., May 27, 2010, at C3 (seeking $8.6 billion in damages). *See also* Julie Creswell, *Lawyer's for Lehman Are Seeking Records from Hedge Funds and Goldman*, N.Y. TIMES, Sept. 1, 2010, at B4.

72. *See* Alison M. Hashmall, *After the Fall: A New Framework to Regulate "Too-Big-To-Fail" Non-Bank Financial Institutions,* 85 N.Y.U. L. Rev. 829, 836-39 (2010) (arguing that the interconnectedness of modern banks and non-bank financial institutions creates systemic risk for the entire economy).

73. *See* Andrew Ross Sorkin, *Lehman Files for Bankruptcy; Merrill Is Sold,* N.Y. TIMES, Sept. 14, 2008, at A1. Consider, as well, lawsuits by and against A.I.G., the formerly private insurance giant now controlled by taxpayers. *See, e.g.*, Serena Ng & Carrick Mollenkamp, *Accusations Fly in a Faulty-Mortgage Lawsuit*, WALL ST. J., Dec. 15, 2010, at C3 (describing a lawsuit filed against A.I.G.); Story & Morgenson, *supra* note 69, at A1 (detail-

man Brothers was the epitome of a non-relational contracting party.[74] And with little interest in the future of its relationships, it did exactly what traditional contract theory would predict—it sought refuge in the legal system in an attempt to realize its reasonable expectations regarding its short-term business dealings.

Litigation was also ubiquitous within a corner of the private investment fund industry itself—albeit one in which the dealings were much less relational than those existing between the fund managers and investors that are the subject of this Article. According to research done by Steven Davidoff, many private equity funds, a type of fund that specializes in leveraged and other buyouts, reneged on their pre-2008 promises to acquire their target companies. Instead, when the time came to close the deal, they claimed that the circumstances had changed and refused to pay the agreed upon purchase price.[75] Rather than forgive their defaulting counter-parties, as did many hedge fund investors and venture capital fund managers, the target companies in these expected leveraged buyouts for the most part sued. Prominent cases involved such industry brand names as Cerberus Capital, Providence Equity Partners, and even the famed Blackstone Group.[76]

Again, however, as with the example of the bankrupt Lehman Brothers, we find that the litigation was commenced primarily by non-relational contractors. According to Davidoff, the contracts that leveraged buyout funds enter into with their targets constitute "short-term relational agreement[s]."[77] Examined more closely, however, the contracts at issue appear to have been much less relational than one might have assumed. In particular, because the deals had not yet been consummated when the breaches occurred, any long-term relationship that was to have existed among the parties had not yet begun. To analogize, the breaches represented not so much a divorce ending years of marriage as the breaking off of a much-anticipated engagement. Regrettable, surely, but not as wrenching to existing familial relations and patterns. In addition, the target companies who initiated the litigation had anticipated making a once-in-a-lifetime

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ing lawsuits brought by A.I.G. against Bank of America, Goldman Sachs, JPMorgan Chase, and Deutsche Bank).

74. Adam Davidson, *Dead Bank Walking*, N.Y. Times Magazine, Sept. 16, 2012, at 16 ("Lehman Brothers is having a great year . . . . Except that Lehman's sole objective is to sell everything it owns so it can repay its lenders and disappear.").

75. Davidoff, *supra* note 9, at 499-502, 510-11. Davidoff blames the failure of private equity funds to complete these deals on a number of factors, among which was the presence of certain contractual provisions that gave the funds both bargaining power and reputational cover in a severely deteriorating market. For example, several deals included MAC clauses that permitted the acquirer to exit the deal in the event of a material adverse change in economic conditions. *Id.* at 500-01. Several others included a relatively new innovation—reverse termination fees—that allowed acquirers to withdraw from a pending deal by paying a predetermined fee (often about three percent of the acquisition price). *Id.* at 496-97, 499.

76. *Id.* at 502-10.

77. *Id.* at 531.

sale. As such, they were not repeat players who needed to protect their reputations in order to engage in multiple transactions within a particular market sector over an extended period. Unlike their counter-parties, their involvement in the world of private equity was a one-time affair.

The widespread presence of litigation within various non-relational sectors of the post-crisis economy, including even a corner of the private investment fund world, thus stands in stark contrast to the dearth of litigation to be found between private investment fund managers and investors. Though similarly situated in terms of their economic context and the overall regulatory environment, many discrete transactors did resort to legal remedies to secure their reasonable expectations. For those not involved in relational affiliations, the insurance function of contract law, as predicted by traditional theory, appears to have held significant value.

E. *The Results*

We have now determined the contours of our natural experiment. The market disruptions caused by the subprime mortgage crisis presented an outside stimulus. Market participants, both discrete and relational, entered into contracts before the crash that appear to have been breached after the crash. But while most non-relational contractors sought to enforce their rights by resort to the judicial system, at least one subset of relational contractors did not.

The most interesting question that now presents itself is why the relational contractors entered into enforceable agreements *ex ante* if it was foreseeable that they would never sue to enforce their rights in the event of breach. For a rational economic actor, why contract if you know you won't sue?

Before moving on, however, we must first take a brief detour in this Part II.E and address an assumption that is built into this question. Interpreting the parties' inaction as indicative of their preferences assumes that their inaction was volitional. If, on the other hand, these players in the private investment fund markets would have preferred to sue but were somehow unable, then their preferences must remain hidden and it would be overstepping the data to conclude that they did not fully value the enforcement function of contract law. Thus, we must first inquire into whether the parties' desire to sue was thwarted due to a lack of resources or the impact of regulatory pressures, whether they preferred to act in response to the breaches but in an extra-legal capacity, and whether 2008 was simply so anomalous as to have resulted in a suspension of the normal rules of the game. Having assessed and then dismissed these possibilities, we can safely conclude that it is the particular economic calculus faced by relational contractors that led them to value their long-term relationships more highly than their short-term losses. Only then, safe in the knowledge that their inaction was indeed indicative of their preferences, can we ask the more profound question—why contract if not to create enforceable rights?

Thwarted Desire to Sue. It is possible that the results of the natural experiment—a dearth of lawsuits among relational contractors as compared to discrete contractors—may best be explained by a finding that all of the parties crafted their agreements with the intention of enforcing them, but that, when the breaches occurred, only the relational contractors found they lacked the resources or sophistication to gain access to the courts. Alternatively, the relational contractors may have preferred to sue but been subject to outside pressures from regulators or others that limited their ability to behave in the manner they desired. For one or another reasons, their silence in the face of breach may have been, on some level, involuntary.

Such a possibility is highly unlikely, however, given our choice of subjects. The world of private investment funds simply does not easily yield to a narrative of imbalances of power or informational asymmetries—at least not with the fund managers on the losing end. In the first place, private investment fund managers and investors represent the elite of the financial world. Even as the nation's economy struggled to recover from the collapse of its credit markets, the twenty-five highest paid hedge fund managers of 2009 took home an *average* of over $1 billion in compensation.[78] Meanwhile, private investment fund investors are often prohibited from investing in even the smallest funds unless they satisfy the Investment Company Act's test for "qualified purchasers."[79] To satisfy this test, investors who are natural persons must maintain a portfolio valued at $5 million, while entities must have portfolios in excess of $25 million.[80] Moreover, many funds require such large commitments as to make trifling even this level of wealth.[81]

Thus, given the extent of their resources, as well as the market savvy that seems likely to accompany such wealth, it appears highly doubtful that the failure of private investment fund managers and investors to sue can be attributed to some infirmity affecting them more severely than those market participants who did in fact opt to sue. If they didn't litigate,

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78. The overall winner, David Tepper of Appaloosa Management, netted in excess of $4 billion. Nelson D. Schwatz & Louise Story, *Pay of Hedge Fund Managers Roared Back Last Year*, N.Y. Times, March 31, 2010, at C1 (recounting data compiled by AR+Alpha, a widely read industry newsletter). By comparison, H. Lawrence Culp, Jr., the Danaher chief identified by *Forbes* magazine as the nation's highest paid executive, brought home just over $140 million. Scott DeCarlo, *What the Boss Makes*, Forbes.com (Apr. 28, 2010 6:00 PM), http://www.forbes.com/2010/04/27/compensation-chief-executive-salary-leadership-boss-10-ceo-compensation-intro.html. Even this comparatively paltry sum is misleadingly large, however, given that most of Culp's compensation came from the vesting of stock options, which take several years to accrue.

79. *See* SEC Hedge Fund Report, *supra* note 19, at 68-70.

80. 15 U.S.C. § 80a-2(a)(51)(A) (2012). Smaller funds organized pursuant to Investment Company Act Section 3(c)(1) can be opened to up to 100 non-Qualified Purchasers but still are generally limited to "accredited investors." *See* SEC Hedge Fund Report, *supra* note 19, at 11-15.

81. Illig, *supra* note 17, at 288-92.

it probably wasn't because they were less able to do so than their non-relational contract parties.

As regards the possibility that the fund managers and investors were operating under the burden of regulation and so were not able to act freely, we can again discount this likelihood based on the nature of the industry. Because they cater to wealthy and institutional investors—whom Congress and the Securities Exchange Commission generally assume to be capable of protecting themselves—private investment funds are free from most disclosure and other securities law obligations.[82] Indeed, so long as they accept contributions only from wealthy investors, the funds operate in something approaching a regulatory vacuum. It would appear, then, that there is little risk that their passivity in the face of counterparty breach was the result of a lesser store of free will than existed in the marketplace generally. Had the fund managers or investors wanted to sue, the regulatory environment would not have thwarted their desire.

Preference for Extra-Legal Enforcement Mechanisms. A second possibility is that the near absence of post-2008 lawsuits among relational contractors could be explained by a preference for extra-legal problem solving. The parties may have genuinely desired to press their rights and resolve their disputes, but via a mechanism other than the American judicial system.

In her paper on the diamond industry's preference for out-of-court dispute resolution, for example, Lisa Bernstein argues that an industry segment will tend to develop extra-legal norms in situations where contract remedies are inadequate.[83] Based on her analysis, it is possible to query whether private investment funds may have avoided resorting to the American legal system in 2008 because they believed that traditional notions of contract law would not guaranty their expectations as well or as efficiently as would privately created sanctions. Factors that tend toward this conclusion include the fund industries' preference for secrecy and the uncertainty associated with the courts' calculation of expectancy damages.[84]

There are important differences between the 2008 credit crisis and the diamond industry of the early 1990s, however. In particular, it appears that the diamond industry studied by Bernstein had opted *en masse* and *ex ante* to avoid the use of legally enforceable contracts, not merely to eschew their enforcement in particular instances of breach.[85] By contrast, the pri-

82. *Id.* at 275-78. The most notable exception to this broad lack of federal regulatory oversight is the parties' continued liability for securities fraud, which generally cannot be avoided. *Id.*

83. Lisa Bernstein, *Opting Out of the Legal System: Extralegal Contractual Relations in the Diamond Industry*, 21 J. Legal Stud. 115, 135 (1992).

84. *See id.* at 135-38 (discussing the factors that make the rules of the American legal system inappropriate for the 1990s worldwide diamond market).

85. *Id.* at 115 ("The diamond industry has systematically rejected state-created law.").

vate investment fund industry relies emphatically on multiple, lengthy, carefully drafted and legally enforceable contracts. Likewise, 1990s diamond dealers frequently challenged one another in front of a private judicial body of their own creation, whereas private investment funds appear to have avoided pressing their rights altogether.[86]

Thus, the situation faced by the two groups is an almost exact inverse—private investment funds appear to value contracts yet shun disputes and formal dispute-resolution systems, whereas diamond dealers engage in disputes with some frequency yet avoid entering into legally enforceable obligations. We can therefore safely discount the possibility that the lack of post-2008 private investment fund litigation was indicative of an industry-wide decision to opt out of American contract law in favor of a private dispute resolution mechanism. They didn't create an alternative mechanism for resolving their disputes. Rather, they left their disputes unresolved.

Implied Covenant of Force Majeure. A third possible explanation for the lack of significant litigation may lie in the fact that the financial collapse of 2008 was itself, though perhaps foreseeable, for the most part unforeseen. A handful of short-sellers placed early bets on the future collapse of the US home mortgage market, and some investors foresaw the collapse before others.[87] Yet, for the most part, the backstory to the market panic lies in the massive delusion that had overtaken nearly all of Wall Street. The crash, however improbable it sounds, took almost everyone by surprise.[88]

On a purely anecdotal level, one senses a lack of palpable anger directed by fund managers and investors at their counterparties. According to many managers, for example, their investors did not overreach or make unreasonable promises. Rather, they—like the managers themselves—were the victims of unforeseen events that had little historical precedent.[89] Many of these relational market participants simply do not appear to have believed that their business partners did anything wrong in the cosmic justice sense, but were instead just as much victims as they. Whether such feelings—if accurate beyond a few isolated examples—were the result of

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86. *Id.* at 124 (reporting that an average of about 150 disputes each year are submitted for resolution by the New York Diamond Dealers Club).

87. For a thoughtful and entertaining account of some of the hedge fund managers who profited greatly by predicting the crash, see generally Lewis, *supra* note 46. Others credited with forecasting the collapse include the likes of Nobel prize-winning economist Joseph Stiglitz and Nobel hopeful Nouriel Roubini. *See, e.g.*, Nouriel Roubini, *Why Central Banks Should Burst Bubbles*, 9 Int'l Fin. 87 (2006); Joseph Stiglitz, *Dealing with Debt: How to Reform the Global Financial System*, Harv. Int'l Rev., Spring 2003, at 54. *See also* Nassim Nicholas Taleb, The Black Swan (2007).

88. *See* Lewis, *supra* note 46, at 256 ("The people on the short side of the subprime mortgage market had gambled with the odds in their favor. The people on the other side—the entire financial system, essentially—had gambled with the odds against them.").

89. *See, e.g.*, Interview with David Chen, Principal, Equilibrium Capital Grp. (Apr. 2, 2010) (notes on file with the author).

years of partnership and common purpose or a reflection of the troubled times, a general feeling seemed to prevail that all of Wall Street was in it together—mutual victims of unforeseeable events. Thus, given that nearly everyone on Wall Street was affected and no one party seemed significantly more culpable than any other, the game of finance may have required a temporary suspension of the rules. Like the cattle ranchers described by Robert Ellickson, Wall Street may have its own set of norms to follow and those norms might include an occasional cease-fire.[90]

Indeed, there is ample precedent for a type of contractual time-out to be found in the nation's great opus of privately negotiated executory contracts. It is common in many negotiated transactions, for example, to include a material adverse change provision. "MAC" clauses, as they are known, permit one party or the other to terminate a pending contract before the deal is consummated in the event of significant changes in the value of the transaction.[91] In this sense, modern MAC clauses are simply updated and refined versions of *force majeure* or act of God provisions.[92] When the world goes haywire, the parties can cancel their deal without blame or negative repercussions.

Meanwhile, contract law itself includes various equitable doctrines, such as frustration of purpose, impracticability, and mutual mistake, which can be used under certain circumstances to argue against holding a breaching party liable.[93] Although such doctrines do not have application in the absence of a lawsuit, they carry significant persuasive and educational power. The parties to private investment fund contracts may thus have internalized the law's normative lessons, thereby making them more sympathetic to crisis-related breach.

As appealing as this image of a selfless Wall Street sounds, however, and although the subprime mortgage crisis was in many ways extraordinary, it is unlikely that the near absence of private investment fund litigation can be explained entirely by the unusual post-crash atmosphere. For one thing, as noted above, MAC clauses are almost universally rejected in the context of private investment fund contracts. Indeed, venture capital fund documents go to great lengths to create the exact opposite result.

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90. *See generally* Robert C. Ellickson, Order Without Law: How Neighbors Settle Disputes (1991).

91. 1 Am. Bar Ass'n, Section of Bus. Law, Comm. on Negotiated Transactions, Model Asset Purchase Agreement with Commentary 98-100 (2001). Generally, the contracts specify what developments qualify as a MAC, and what developments don't. Typically, changes in "the business, operations, prospects, assets, results of operations or condition (financial or other) of Seller" qualify as an excuse, *id.* at 98, whereas developments that affect the seller's industry as a whole or that result from the announcement of the transaction do not. *Id.*

92. *See* 6 Arthur Linton Corbin, Corbin on Contracts: A Comprehensive Treatise on the Working Rules of Contract Law § 1324 (1962).

93. Restatement (Second) of Contracts § 265 (1979) (discharge by supervening frustration); *id.* at § 261 (discharge by supervening impracticality); *id.* at § 152 (mutual mistake).

Parties who fail to perform are subject to harsh penalties whatever the cause. In addition, recent caselaw that interprets MAC clauses narrowly may suggest a shift in thinking. For example, in 2001, the Delaware Chancery Court held that a $100 million write-down by IBP, combined with a 40% downgrade in its reported earnings, was not sufficient to trigger the negotiated MAC clause and so release Tyson Foods from its obligation to acquire IBP.[94] The positive reaction to this and other similar rulings among both academics and the practicing bar suggest a discomfort with mechanisms that too easily release a contract party from its obligation to perform.[95] Thus, we should not be too quick to assume that the atmosphere on Wall Street makes parties to private investment fund contracts eager to absolve one another of their breaches.

More importantly, there is no reason to think that this kind of industry-wide suspension of the rules should be concentrated among hedge funds and venture capital funds. Rather, if 2008 was simply an anomaly with no descriptive power, we should expect to see the same reaction by all market participants, whether relational or discrete, not a dearth of lawsuits concentrated within a particular group of relational contractors.

It appears, then, that while the abnormal circumstances of the post-crash period may have had some influence on the lack of litigation among private investment fund managers and investors, something more was likely going on. To the extent this subset of relational contractors was uncomfortable suing its business partners (though that discomfort may have been heightened by the unusual climate prevailing in 2008-2009), we must look to the specific attributes of the private investment fund industry to understand its anomalous response. Why was it that only relational contractors forgave their counterparties' breaches?

Reputational Economics. As we have seen, the contracts governing private investment funds are generally highly relational. The funds themselves often last as long as seven to ten years, making such arrangements

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94. *See In re* IBP, Inc. S'holders Litig., 789 A.2d 14, 67 (Del. Ch. 2001) ("To a short-term speculator, the failure of a company to meet analysts' projected earnings for a quarter could be highly material. Such a failure is less important to an acquiror who seeks to purchase the company as part of a long-term strategy."). *See also* Esplanade Oil & Gas, Inc. v. Templeton Energy Income Corp., 889 F.2d 621 (5th Cir. 1989); Borders v. KRLB, Inc., 727 S.W.2d 357 (Tex. App. 1987).

95. *See, e.g.*, Jordan A. Goldstein, *The Efficiency of Specific Performance in Stock-for-Stock Mergers*, 29 Del. J. Corp. L. 747, 765 (2004) ("According to Anthony Kronman, the current state of the law with which the *IBP* court dealt succeeds quite well in supporting the ex ante intent of most parties."); Jonathon M. Grech, Comment, *"Opting Out": Defining the Material Adverse Change Clause in a Volatile Economy*, 52 Emory L.J. 1483, 1512-14 (2003) (noting that *Tyson*'s "'penalty default rule' produces efficient results because it forces the buyer 'either to take precaution or reveal the risk to the other party and pay him to assume it.'"); Nathan Somogie, Note, *Failure of a "Basic Assumption": The Emerging Standard for Excuse Under MAE Provisions*, 108 Mich. L. Rev. 81, 110 (2009) (noting that the decision in *Tyson* was "consistent with the outcomes we would expect to see under the 'basic assumption' test.").

true partnerships rather than one-off exchanges.[96] Moreover, it is not at all uncommon for investors to re-up with successful managers when they organize follow-on funds, thereby extending and expanding the relationship even further.[97]

Adding to the long-term nature of private investment fund relationships is the relatively closed set of players involved in the industry. Because of the large sums involved, the pool of potential investors is comparatively small and surprisingly static.[98] And the opposite is also true; institutional investors have only so many high quality funds from which to choose. Anyone can organize a fund, but it takes talent to run one profitably.[99] The private investment fund industry thus appears to operate like one of the close-knit communal economies studied by Bernstein and Ellickson.

The result is that private investment fund managers and investors rely heavily on their reputations in order to invest and profit. Investors fear that if they become known as troublemakers, the most profitable funds will spurn their money. Likewise, managers fear that, if they gain a reputation for suing their investors, their future sources of financing will dry up. In a small and static community, reputation is currency.[100] And within the world of private investment funds, it acts as a strong incentive for all parties to get along and not be perceived as rocking the boat, espe-

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96. Private Equity Terms & Conditions, *supra* note 21, at 13.

97. *See* Pui-Wing Tam, *Venture Capital Hits a Cash-Call Crunch*, Wall. St. J., Dec. 8, 2008, at C1 (noting that, although reneging on capital calls may constitute a breach of contract, "there are few precedents for venture-capital and private-equity funds suing their investors, since they need to maintain long-term relationships with the investment community.").

98. Indeed, because it is unwise to invest all of one's assets in a single asset class, private equity fund investors must have assets well in excess of those they invest in hedge funds and venture capital funds. A common pension fund portfolio, for example, might be invested primarily in traditional asset classes such as marketable securities and bonds and only partly in "alternative investments," a category that includes absolute return (or hedge fund) investments, real estate, and private equity (including venture capital). *See* David F. Swensen, Pioneering Portfolio Management: An Unconventional Approach to Institutional Investment 114-18 (2000).

99. *See* Private Equity Terms & Conditions, *supra* note 21, at 7-8 (surveying market conditions circa 2006-2007 and concluding that investors "are demanding concessions that would have been unthinkable even a year ago in exchange for their money."); *id.* at 37-38 (noting that formulas for calculating manager compensation vary depending upon past performance).

100. *See* Eric A. Posner, Law and Social Norms 12 (2000) ("Sometimes people keep their promises not because they fear being sued, but because they fear developing a bad reputation. If they develop a bad reputation, it will be harder for them to find work and to obtain other good things in the future."); David Charny, *Nonlegal Sanctions in Commercial Relationships*, 104 Harv. L. Rev. 373, 393 (1990) ("If the promisor improperly breaches his commitments, he damages his reputation and thereby loses valuable opportunities for future trade.").

cially in an atmosphere like that of 2008 in which no one player seemed particularly more culpable than any other.[101]

What we encounter in the post-2008 world of private investment funds, then, is a situation where there were strong incentives among parties to relational contracts to avoid resort to the legal system to resolve their disputes. The decision to sue one's business partner involves an obvious tradeoff between short- and long-term benefits and losses. Given the inherently adversarial nature of litigation, coupled with the importance of reputation, if a relational market participant initiated a lawsuit, she would gain only the possibility of obtaining a near-term, one-time payment while certainly destroying a long-term financial partnership (and possibly her reputation for fair dealing). If, on the other hand, the relational contractor refrained from suing, she would forego the opportunity to recover a near-term loss but retain the potential for a fruitful future.

Thus, as rational economic players, fund managers and investors most likely believed it was in their best interests to waive any breaches in order to maintain their standing vis-à-vis their counterparties and within their industry. Once the subprime dust settled and the economy found some level of post-crash equilibrium, many investors and fund managers hoped and expected to once again conduct business with one another.[102] Ultimately, then, private investment fund managers and investors didn't sue one another because, in the long run, they believed litigation was a losing proposition.

The problem that this analysis raises, however, is that there is nothing about the nature or quality of the events of 2008 that made such an economic calculus unforeseeable (even if the particular timing and nature of the crash may have indeed been unforeseen). As highlighted above, the private investment fund industry is composed of sophisticated and wealthy participants who could have predicted that they would value their long-term partnerships more highly than any short-term recoupment of losses.

Why, then, did they bother to contract in the first place? Why would rational economic players expend the resources to negotiate formal, legally binding, written agreements, if not to enforce them? Contracting is not without transaction costs, and the process consumes a finite—and not insignificant—resource in the form of management time and energy. So what is it about the American contract law regime that was appealing to this subset of relational contractors, if not the opportunity to enforce their negotiated rights in court? What made them eager to contract despite their reluctance to sue? This is the question addressed in Part III.

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101. Reputational concerns seem slightly less important with regards to the enactment of hedge fund gates, however. Zuckerman, *supra* note 61, at D3 (reporting that the stigma associated with freezing redemptions appears to have been abating as more and more funds did so).

102. Interview with Jay Namyet, Chief Investment Officer, University of Oregon Foundation, in Eugene, Or. (April 15, 2010) (notes on file with the author).

F. *Notes on Methodology*

Before addressing the question of why relational contractors might value having a contract if not for enforcement purposes, it is important to note several observations about this Article's methodology.

First, I have characterized the varying responses of certain relational and discrete contractors to the economic disruptions of 2008-2009 as constituting a "natural experiment." Natural experiments are a form of observational study sometimes used in the social sciences as an alternative to randomized controlled experiments.[103] What distinguishes them from other forms of observational studies is the occurrence of some arbitrary event that appears to divide test subjects haphazardly into two groups.[104]

There are inherent dangers in the design of any experiment that are especially salient in the context of a natural experiment. Among them is the possibility of variables existing between the two groups that the researcher cannot control and which may be the real cause for the observed results.[105] Equally important is the risk that the assignment of subject groups may not in fact be random. Indeed, it is often the case that investigators involved in natural experiments study the wrong groups and hence draw erroneous conclusions.[106]

Moreover, the "natural experiment" I describe in this Article differs in fundamental respects from a true natural experiment. In a true natural experiment, a single group of subjects is divided into two subgroups, only one of which is subjected to the treatment. In this case, however, we have two subgroups—relational and discrete contractors—who were both subjected to the identical treatment, the economic disruptions of 2008. Thus, it is possible that some other, unknown factor caused the players in the private investment fund industry to both value relational contracts and dislike litigation. The observed behavior may be correlated rather than casually related.[107] I may also have been mistaken to divide the subjects based on the degree of their relationality. Some other grouping of traits may be more significant.

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103. Thad Dunning, *Improving Causal inference: Strengths and Limitations of Natural Experiments*, 61 Pol. Res. Q. 282, 282 (2008) ("As the name suggests, natural experiments take their inspiration from the experimental approach."). Similar to a natural experiment is a "quasi-experiment" in which the treatment and control groups were not assigned randomly. *Id.* at 289.

104. Bruce D. Meyer, *Natural and Quasi-Experiments in Economics*, 13 J. Bus. & Econ. Stat. 151, 151 (1995) ("Good natural experiments are studies in which there is a transparent exogenous source of variation in the explanatory variables that determine the treatment assignment."). Typical examples of such "as if randomization" events include political redistricting, lottery results, and weather events. Dunning, *supra* note 103, at 287-88.

105. Donald B. Rubin, *Estimating Causal Effects of Treatments in Randomized and Nonrandomized Studies*, 66 J. Educ. Psychol. 688, 698-99 (1974).

106. *See* Jasjeet S. Sekhon & Rocio Titiunik, *When Natural Experiments Are Neither Natural nor Experiments*, 106 Am. Pol. Sci. Rev. 35, 35 (2012).

107. *See* Dunning, *supra* note 103, at 291 (noting that it is often difficult in the social sciences to construct experiments that yield valid causal inferences).

Despite these risks, natural experiments can serve as valuable research tools when considered within a larger body of research.[108] They remove the sense of artificiality that comes from watching rats maneuver through a man-made maze or studying a computer model that seeks to approximate real life. They also provide the opportunity to uncover relationships or other results that may have lain hidden beyond the researcher's imagination and thus expand the potential for surprise.

It is also possible to limit the risks associated with natural experiments through a combination of *a priori* reasoning and hard thinking about both the assignment of groups and the possible occurrence of uncontrolled variables.[109] Thus, even if a particular study were to fail a rigorous test of its design, it may prove to constitute the best available evidence of a hidden or hard-to-measure phenomenon.

In this respect, the particular attributes of the private investment fund industry serve to strengthen the inferences I draw from their post-crash behavior. Private investment fund managers and investors, as we have seen, are in most cases highly sophisticated and have access to extensive resources. They are also largely unregulated and thus not influenced by artificial legal structures.[110] Given this state of affairs, one might expect private investment funds to be better able to gain access to judicial remedies and more likely to press their rights than the average economic player. Their characteristics as test subjects thus appear to run counter to the most likely risks inherent in this Article's methodology. The fact that the funds generally sought to avoid litigation therefore seems unlikely to be the result of an unaccounted-for variable like wealth, sophistication, or the impact of the political economy. Rather, the primary variable of relationality appears, based on *a priori* reasoning and close observation rather than on strict randomized experimentation, to be the most relevant factor.

More importantly, the conclusions I seek to draw in this instance do not depend upon some absolute proof of causality. Rather, it is sufficient to highlight the distinctive manner in which different market participants reacted to the wave of breaches that followed in the wake of the 2008 crisis. Whether the variability in the parties' responses is caused by their relative degree of relationality or whether both are caused by some third factor, the fact remains that an identifiable subgroup of market participants behaved in 2008-2009 in a manner that suggests they value contract law for reasons other than as insurer of their reasonable expectations. As a result, whatever the cause, it is reasonable to inquire as to what value that group does place on contract law, as well as on how contract law should respond to such varying preferences among market players.

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108. *Id.* at 290.

109. Rubin, *supra* note 105, at 700 ("In both randomized and nonrandomized studies, the investigator should think hard about variables besides the treatment that may causally affect [the dependent variable] and plan in advance how to control for the important ones . . . ."); Dunning, *supra* note 103, at 290.

110. *See supra* notes 78-82 and accompanying text.

When combined with a larger mix of research efforts, this Article's conclusions serve not as a definitive account of the cause of the parties' behavior, but as a clue toward a deeper understanding as to the manner in which they use and value contract law. I therefore recommend this Article's methodology and conclusions as an important piece of a larger theoretical inquiry that can and should be approached simultaneously from a variety of directions.

III. Why Relational Parties Contract

Classical and neo-classical approaches to contract law are both fundamentally oriented toward the goal of insuring the parties' reasonable expectations.[111] By putting the force of public law behind the words of a privately negotiated contract, the state seeks to remove from commercial transactions the risk of counterparty non-performance.[112] In doing so, contract law reduces the informational costs associated with transacting and permits the parties to alter their economic position with relative confidence. The result is a highly functioning, modern economy in which it is generally safe to conduct business with strangers.

That being said, the reluctance of a large and sophisticated set of relational market participants to enforce their rights post-Lehman Brothers would appear to undercut this basic premise of contract law. Assuming that the fund managers and investors are rational economic players, and that they have the wealth and savvy to make shrewd financial decisions regarding the allocation of resources, they must have contracted for some reason other than to obtain a government-sponsored guaranty of their expectations. For them, the value of contract law must lie elsewhere. Part III therefore examines and assesses two possible justifications for relational market participants to engage in contracting that are distinct from contract law's function as insurer of the parties' reasonable expectations: symbolism and ceremony.

A. *Symbolic Value*

In addition to serving as an abstract store of words that create legal consequence, a contract is an object—a piece of paper covered in ink. As such, it has the potential to provide value as a symbol or icon whose mere existence may be of importance to relational market participants. They may value a contract not for its legally enforceable allocations of duty and risk, but for its symbolic meaning as an imprimatur of insider status. Additionally, they may believe they benefit from the existence of an object that represents a physical manifestation or totem symbolizing the parties' close and ongoing connection.

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111. *See, e.g.,* Restatement, *supra* note 93, § 1 ("A contract is a promise or a set of promises for the breach of which the law gives a remedy. . . .").

112. *See* Farnsworth, *supra* note 3, § 1.3, at 8.

Imprimatur of Sophistication. In practice as well as in theory, almost anyone can form a private investment fund. Indeed, the barriers to entry are almost non-existent. All it takes are a few computers, a brokerage account, some legal advice, and start-up costs. There are even ridiculous-sounding websites offering start-up and administrative assistance to founders of new funds.[113]

One of the challenges for expert fund managers, then, is how to distinguish oneself from the crowd. This situation constitutes a form of the well-known lemon effect, whereby investors potentially under-value and thus under-invest in all funds because they cannot be sure which are the good ones.[114] To alleviate this possibility, high-quality managers must attempt to differentiate the market by adopting a set of common yet subtle signals that are transparent to investors but opaque to would-be new managers. Such elements operate as a seal of approval or membership card, serving to distinguish those with insider status from relative newcomers or other market interlopers.

One example of such an imprimatur in the private investment fund industry is the choice of legal counsel. The signaling role that lawyers play can be observed indirectly by examining the concentration of deals among a top tier of law firms. Rankings by *Private Equity Analyst* suggest that the top four private equity/venture capital law firms provided counsel in substantially more deals in 2008 as did the next ten firms, and that these top fourteen advised in substantially more deals than did the next fifty-eight.[115] The market for private investment fund legal services, in other words, is dominated by a select group of identifiable firms who advise on a vastly disproportionate number of transactions. Nor are these firms the same as those that lead the most M&A or securities transactions, meaning that we are identifying not a top tier of general business firms but a top tier of private equity and venture capital firms.[116] Knowing enough to engage one of these firms can therefore serve as evidence of one's sophistication (or ability and inclination to purchase such sophistication). Ac-

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113. *See, e.g.*, START A HEDGE FUND NOW, http://startahedgefundnow.com (last visited Oct. 26, 2012); TURNKEY HEDGE FUNDS, http://turnkeyhedgefunds.com (last visited Oct. 26, 2012).

114. *See generally* George A. Akerlof, *The Market for "Lemons": Quality, Uncertainty and the Market Mechanism*, 84 Q. J. ECON. 488 (1970) (analogizing from the price-reducing effects of uncertainty in used-car sales to markets generally).

115. Sabrina Willmer, *Most Active Law Firms*, DOW JONES PRIVATE EQUITY ANALYST, May 2009, at 22-23, *available at* www.goodwinprocter.com/files/otherarticles/PE%20analyst%20.pdf (ranking seventy-two firms based on self-reported data). Meanwhile, Davidoff reports that as few as twenty-two law firms were involved in 91% of all large LBO private equity investments in target companies between 2004 and 2007. Davidoff, *supra* note 9, at 535-37.

116. For recent rankings of law firms advising on mergers and IPOs, see *League Tables of Legal Advisors to M&A for Year End 2011*, MERGERMARKT.COM, (Jan. 13, 2012), http://www.mergermarket.com/pdf/Press_Release_for_Legal_Advisers_Year_End_2011.pdf; *Bloomberg 2012 1st Half Global Legal Advisor League Tables*, BLOOMBERG.COM (June 30, 2012), http://about.bloomberg.com/pdf/gla.pdf.

cording to scholars of the lawyering process like Karl Okamoto and Richard Painter, these lawyers are vouching for their clients' standing by leasing to them their firm's reputation.[117]

Another potential badge of insider status relates to the funds' legal structure and financial terms. There is no tax or other regulatory reason that a fund could not be formed as an LLC, for example, yet there is a lingering preference among managers for limited partnerships.[118] One possible explanation for this choice is that it creates an imprimatur denoting insider status. A clever lawyer or manager who is new to the industry might plausibly structure the fund as an LLC, but insiders realize that such a choice is outside the norm. The same is true of the industry's traditional "two-and-twenty" fee structure. Another structure is certainly possible, but it simply isn't done—at least not by those in the know.[119]

Taking this idea to its logical conclusion, then, there is reason to believe that investors and managers benefit from contracting in part because their acquisition of the "right" set of contracts serves as evidence that they are members of the insider club. They contract even if they believe the words themselves will never be enforced, because doing so vouches for their sophistication and marks them as professionals. Or, considered in the alternative, arriving at a potential investor's office with the wrong set of contracts would instantly mark the manager as a newcomer or outsider who might not be trusted with such large amounts of capital. Indeed, the more standardized the contracts become, the greater their impact as abstract symbols of insider status,[120] so long as the standardized terms remain relatively opaque to the outside world.

Nor are a contract's signaling benefits of value only vis-à-vis the drafter's counterparty. Rather, a contract between a fund and its investors can be utilized by the fund to enhance its search for quality investments. Prominent examples of contracts as totems that augment bargaining power include a firm commitment letter from a Wall Street bank that denotes the ability of its holder to quickly execute a deal, as well as a once-feared "highly confident letter" from investment banker Michael Milken

117. *See* Karl S. Okamoto, *Reputation and the Value of Lawyers*, 74 Or. L. Rev. 15, 22-26 (1995) (arguing that one of the distinguishing characteristics of elite law firms is their ability to serve as "reputational intermediaries" for their clients); Richard W. Painter, *Toward a Market for Lawyer Disclosure Services: In Search of Optimal Whistleblowing Rules*, 63 Geo. Wash. L. Rev. 221, 267-74 (1995) (advocating a regime under which lawyers reduce client transaction and regulatory costs by certifying their good conduct).

118. *See* Private Equity Terms & Conditions, *supra* note 21, at 6.

119. *See Id.*

120. *See* Suchman, *supra* note 4, at 111 (advocating that scholars approach the notion of contract as a "sacred symbol"). One might even posit that it would be unnecessary for investment contracts to retain their present form in order to have this effect. Were the fourteen or so top law firms to meet and decide otherwise, for example, contracts could theoretically be replaced with a special ID card, a secret password, or even a midnight ceremony under the moon. Each, if made sufficiently difficult to discover, would serve the goal of separating the insiders from the outsiders and so serve as an effective counter to the lemon effect.

that signified its holder's ability to launch a hostile takeover.[121] In a like manner, a document containing a promise from the mighty CalPERS to contribute to a fund can serve as a powerful selling point for a fund attempting to entice a promising dotcom to select it from among its potential suitors.[122] Such a commitment demonstrates not only that the fund is serious and ready to deal, but that its sophistication and market savvy have already been vouched for by the experts. For a relational market participant interested in signaling its insider prestige, a documentary manifestation of that status may hold real appeal whether or not it also creates enforceable legal rights.

Symbol of the Covenant. Closely related to the ability of a written contract to serve as an imprimatur of its holders' status is its ability to act as a verification of the existence of their relationship. Like a wedding ring, deal toy, or t-shirt emblazoned with an employer's logo, a written contract can serve as a reminder that the parties are not mere strangers in the economic crowd but partners in some long-term endeavor. In the manner that many Christians view the act of communion as God's covenant made flesh, a written contract serves as a tangible representation of an abstract relationship.

Serving in this symbolic capacity, a contract may have three constructive aspects. First, it is a confirmation of social norms. Many contracting parties fulfill their promises not because of the existence of consideration or the application of principles of promissory estoppel, but because they believe it is their duty to honor their promises.[123] A tangible reminder of that promise can therefore serve a helpful normative function in addition to its legal role. Indeed, there is ample evidence from the field of psychology suggesting that people are more likely to behave with integrity if they have recently been primed to think about the importance of honesty.[124]

Second, even if sophisticated parties to a contract themselves understand that they are unlikely to resort to legal action in the event of a breach, the contract as such may retain much of its deterrent effect. If the language of the contract is clear, on point, and in the injured party's favor, actual resort to the legal system may prove unnecessary. Even a hollow threat, if undetected by the other party, retains its power to intimidate. In this respect, the mere existence of a contract can serve as an alternative to

121. *See* Arnoud W. A. Boot, Stuart I. Greenbaum, & Anjan V. Thakor, *Reputation and Discretion in Financial Contracting*, 83 Am. Econ. Rev. 1165, 1176 (1993).

122. *See, e.g.,* Nicole Perlroth, *Venture Capital Firms, Once Discreet, Learn the Promotional Game,* N.Y. Times, July 23, 2012, at B1 ("The best entrepreneurs are courted by the venture capitalists, not the other way around.").

123. Tess Wilkinson-Ryan & David A. Hoffman, *Breach Is For Suckers*, 63 Vand. L. Rev. 1003, 1015-16 (2010) ("Psychology researchers have found that ordinary citizens believe that they are legally and morally bound by the language of a contract they have signed even if parts of the contract are in fact unenforceable.") (citations omitted).

124. *See, e.g.,* Clive Thompson, *The Eyes of Honesty*, N.Y. Times Mag., Dec. 10, 2006, at 48.

traditional dispute resolution.[125] Evidence of this phenomenon can be found in the frequency with which employers demand that their employees sign contracts that are unlikely to be enforced or even enforceable.[126] Family law is similarly replete with agreements that are honored by the parties without regard to their enforceability as contracts.[127] Integrity can often substitute for legal sanction, and any reminder that encourages trustworthy dealing holds obvious value.

Third, as Lon Fuller has observed, contractual formalities serve a cautionary function.[128] Being presented with a formal, written agreement may bring the significance of the parties' impending responsibilities to their attention in a meaningful fashion. As a result, the mere existence of the contract may act as a check against "inconsiderate action."[129]

For relational market participants, then, merely having a contract may be as or more valuable than enforcing a contract. As an imprimatur of one's status, a manifestation of a commitment to work cooperatively, and a warning against inconsiderate action, a written contract can serve important symbolic functions that exist above and apart from its value as a store of legally enforceable promises.

B. *Ceremonial Value*

A second way in which contracts provide value, apart from their role as insurers of reasonable expectations, is as a process. Contracts, after all, do not pop in and out of existence wholly formed like some misbehaving subatomic particle, but must be carefully structured, negotiated and drafted in a time-consuming and generally face-to-face manner.[130] For relational market participants, the opportunity to engage with one's business partners in the activity of contracting may hold appeal as a method for improving the end result, as a means for strengthening the bonds that hold the

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125. *See, e.g.,* Russell Korobkin, *The Role of Law in Settlement*, *in* THE HANDBOOK OF DISPUTE RESOLUTION 254, 254-55 (Michael L. Moffitt & Robert C. Bordone, eds., 2005), *available at* http://ssrn.com/abstract=601505.

126. *See* Deborah A. Schmedemann & Judi Mclean Parks, *Contract Formation and Employee Handbooks: Legal, Psychological and Empirical Analyses*, 29 WAKE FOREST L. REV. 647, 665 (1994) ("Rousseau's study of M.B.A. graduates about to begin their first jobs documents psychological contracts. Even at this early stage in the relationship, the new employees spoke of reciprocal obligations between the parties. Employees saw a *quid pro quo* between their obligation to be loyal and stay for a minimum period of time and the employer's obligation to provide job security; where the employee had no such obligation, neither did the employer.").

127. *See, e.g.*, MARGARET F. BRINIG, FROM CONTRACT TO COVENANT: BEYOND THE LAW AND ECONOMICS OF THE FAMILY 1 (2000) ("[T]oday we find families whose covenants derive most of their power from the family members' mutual commitment to one another and to the preservation and protection of the family itself.").

128. Lon L. Fuller, *Consideration and Form*, 41 COLUM. L. REV. 799, 800 (1941).

129. *Id.*

130. *See generally* AM. BAR ASS'N, SECTION OF BUS. LAW, COMM. ON NEGOTIATED TRANSACTIONS, THE M&A PROCESS (2005) [hereafter, M&A PROCESS].

parties together, and as a ritual rite of passage signifying for the parties the birth of their new economic reality.

Bounded Rationality. It is of course axiomatic that human beings lack the mental capacity to foresee, let alone plan for, all possible future contingencies. As a result of what economists refer to as our "bounded rationality," no contract can possibly be complete, no matter how clever its drafters.[131]

Fortunately, the law and legal practice have developed various correctives intended to minimize the problem of imperfect contracts. So-called implied or constructive terms, for example, are provided by contract law in order to help flesh out provisions that were omitted or dealt with in overly cursory fashion.[132] The use by contract drafters of imprecise standards of conduct, including "best efforts" and "reasonable notice," similarly aim to prevent parties from taking advantage of vague or incomplete terms.[133] Indeed, Ronald Gilson has argued that the chief function of business lawyers is to devise legal structures that minimize the mistakes and inefficiencies inherent in transacting.[134] Despite these palliatives, however, our courts are replete with examples of contracts that failed the test of perfection and for which no antidote was available.

This inability of contracting parties to address all future contingencies suggests at least a partial explanation for why a party might value the process of contracting even if she does not value the resulting contract. The very process of contracting forces the parties to reflect on a much wider range of possible contingencies than they may have considered without the requirement of putting it all down on paper in concrete and detailed fashion. The devil, as we have heard, resides in the details. The contracting process is therefore valuable in and of itself for the obvious reason that the group effort and mental discipline that it requires partially offset the inherent limitations of the human mind.

Considered as a process rather than a creation, contracts thus provide a foundation of mutual understanding and an opportunity for discussion, even if the end result is never adhered to or even executed. Family law scholars, for example, have long understood the value of contracting as an opportunity for counseling and planning rather than merely as a means for producing legal rights that are unlikely ever to be enforced.[135] In this re-

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131. *See generally* Bryan D. Jones, *Bounded Rationality*, 2 Ann. Rev. Pol. Sci. 297 (1999).

132. *See* Farnsworth, *supra* note 3, § 7.16.

133. *See Id.* § 3.28. *See also* James C. Freund, Anatomy of a Merger: Strategies and Techniques for Negotiating Corporate Acquisitions § 8.2.1.

134. Ronald J. Gilson, *Value Creation by Business Lawyers: Legal Skills and Asset Pricing*, 94 Yale L.J. 239, 255 (1984) ("I suggest that the tie between legal skills and transaction value is the business lawyer's ability to create a transactional structure which reduces transaction costs and therefore results in more accurate asset pricing.").

135. *See, e.g.*, Elizabeth S. Scott & Robert E. Scott, *Marriage as Relational Contract*, 84 Va. L. Rev. 1225, 1229 (1998).

spect, it is as an exercise in legal imagination, rather than as the basis for changed legal rights, that a contract has value.[136]

Bonding. Closely related to the planning and educational functions of contracting is the notion that the process involved in creating a contract provides an opportunity to build and strengthen personal relationships among the parties.

The process of negotiating a contract, with its necessary compromises and efforts to understand the other's position, can generate empathy and introduce the parties to their future partners' temperaments, values and styles of doing business.[137] Embedded in the planning for future contingencies are lessons as to the social expectations of the parties. The closing itself serves as an attestation of the ability of the parties to work together under difficult circumstances and to accomplish a hard-to-reach goal. Like sharing a summer at sleep-away camp, the act of staying up late, night after night, to finish a difficult project can generate lasting bonds and feelings of shared achievement. Before even commencing the relationship, the parties have already attained a significant—and mutual—victory.

The mere process of contracting, then, can add value by strengthening bonds and decreasing the likelihood of misunderstandings. According to Lisa Bernstein, this kind of bonding often predominates within "geographically concentrated, homogenous groups who deal with each other in repeated transactions over the long run."[138] Even absent such idealized circumstances, important bonding can take place between parties to a particular deal and encourage them to act fairly and reasonably in all of their dealings.[139]

For Bernstein, the uniqueness of the diamond industry of the 1990s lies in the fact that its participants had been successful in lowering the costs of reputational bonds to the degree that it became more efficient to enforce rights outside of the legal system than within it.[140] She is thus making a Coasian argument about the nature of legal rules versus reputation—industry segments will tend to rely on whichever is the more efficient at

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136. For an explanation of the importance of "legal imagination," see Todd D. Rakoff & Martha Minow, *A Case for Another Case Method*, 60 VAND. L. REV. 597, 602 (2007) (arguing for the importance of "the ability to generate the multiple characterizations, multiple versions, multiple pathways, and multiple solutions, to which [lawyers] could apply their very well honed analytic skills.").

137. *See* POSNER, *supra* note 100, at 13 ("Failure to conform to relevant social norms raises suspicions about [an employee's] character and reliability in relationships of trust, even when there is no direct relationship between the deviant behavior and the requirements of the job."); Suchman, *supra* note 4, at 111 ("[C]ontract rituals provide symbolic reassurance that the parties are entering into a predictable, controllable, and mutual relationship within a social order composed of voluntary arm's length exchanges between equally endowed strangers.").

138. Bernstein, *supra* note 83, at 140.

139. *See id.* at 140-43.

140. *Id.* at 138.

reducing transaction costs.[141] What this means is that anything that helps build confidence and empathy among future business partners, including various social gatherings and other rituals, may also serve to generate bonds and minimize disputes.[142] Contracting as bonding mechanism therefore has real and measurable value.

Ritual Rite of Passage. Over time and across cultures, societies have evolved various rituals and rites of passage to mark important transitions. These include anything from weddings, graduations and funerals, to various coming-of-age ceremonies. Anthropologists identify such rites as composing certain common elements and symbolic gestures—such as a kiss, the handing over of a diploma, or the closing of a casket—that signify in a visible and tangible manner a moment of transition from one state or status to another.[143] Although such rituals may focus on only one or two primary participants, they generally involve large groups of witnesses and other contributors. Frequently, they involve some sort of appeal to the supernatural.[144]

According to the structural-functional school of anthropology, the point of these rituals is to reinforce social norms and class distinctions.[145] By marking clear boundaries between one rank or status and another, rituals create walls of differentiation. But ritual is also transformative, an indication of social change. All the way up to the time that one loudly pronounces "I do," one remains a bachelor with no unbreakable social obligations outside of one's existing family. Complete the rite and say the magic words, however, and everything is different—the one-time bachelor becomes a husband or wife and a member of a whole new family, a relationship that can be severed only through formal governmental intervention. The ritual of the wedding marks a clear division between two very different social categories and so highlights their distinctive qualities. To use the words of Victor Turner, anthropology's leading expert on ritual,

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141. *See generally* R. J. Coase, *The Problem of Social Cost*, 3 J. L. & ECON. 1 (1960).

142. *See* Davidoff, *supra* note 9, at 519 ("The acquisition contract and its negotiation also served as a bonding mechanism, enhancing these norms and constraints. The negotiation process not only established the legal parameters of the agreement but, in the discourse of the parties, also established a relationship to sustain the transaction.").

143. ARNOLD VAN GENNEP, THE RITES OF PASSAGE 2-3 (Monika B. Vizedom & Gabrielle L. Caffee, trans. 1960) (originally published in French in 1908) ("For every one of these events there are ceremonies whose essential purpose is to enable the individual to pass from one defined position to another . . . . Thus we encounter a wide degree of general similarity among ceremonies of birth, childhood, social puberty, betrothal, marriage, pregnancy, fatherhood, initiation into religious societies and funerals.").

144. *See*, *e.g.*, BOBBY C. ALEXANDER, VICTOR TURNER REVISITED: RITUAL AS SOCIAL CHANGE 20 (1991). *See also*, *e.g.*, *id.* at 152 ("Ritual liminality breaks human limits, opening up the possibility of full humanity . . . a model for human transformation at the highest, or spiritual, level.").

145. *Id.* at 3.

the performance of certain rites "creates, or re-creates, the categories through which men perceive reality."[146]

Given this definition, it is hard not to view the process of negotiating a complex financial agreement as a form of ritual intended to highlight the parties' new status as co-adventurers.[147] The ritual of negotiations follow a more or less prescribed pattern and certain rites are observed, such as the signing and delivery of the documents. We even have a name for the actual moment of transition—the Closing. And though there is rarely an appeal to the supernatural, there is a direct and formal appeal to the law as a higher power with the ability to enforce the parties' new reality. Indeed, like the shamans of tribal societies, attorneys frequently offer their formal opinions that their deity (in this case, the blindfolded lady justice) will respect and honor the terms of the transition.[148]

According to turn-of-the-century French anthropologist Arnold van Gennep, a ritual rite of passage like a marriage has three distinct aspects: rites of separation, rites of transition, and rites of incorporation.[149] Under this scheme, the engagement preceding the actual wedding focuses the participants' attention on their upcoming *departure* from a prior reality and its associated set of norms, while the transition planning and the wedding ceremony itself highlight their *union* and the creation of a new relationship.

Here again we can see in the act of signing an analogy to the engagement, wherein a departure or transition is set in motion but not yet completed. Next, during the interim period between signing and closing a contract, we can witness a transition wherein obligations to the other are heightened but not yet completely certain. During this phase, the parties may be obligated to share information and use their best efforts to move the transaction forward, for example, but the deal is not yet complete.[150] Likewise, upon closing, we have a clear-cut moment at which a new relationship, and oftentimes a whole new entity, is created.

Viewing contracting as a form of ritual that formally marks the creation of a new relationship highlights another important reason why parties would want to engage in the process of contracting: to highlight their new social status as business partners. When forming a venture capital fund or investing in a hedge fund, for example, the parties are exposing themselves to significant counterparty compliance risk. As a result of bounded rationality, they must trust, to a significant degree, in the power of norms, stan-

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146. V. W. Turner, The Drums of Affliction: A Study of Religious Processes Among the Ndembu of Zambia 7 (1968).

147. *See* D. Gordon Smith & Brayden G. King, *Contracts as Organizations*, 51 Ariz. L. Rev. 1, 39 (2009) (highlighting the "ceremonial function" of contract).

148. *See* II Comm. on Negotiated Transactions, Section of Bus. Law, A.B.A., Model Asset Purchase Agreement with Commentary: Exhibits, Ancillary Documents and Appendices 67-68 (2001).

149. Gennep, *supra* note 143, at 10-11.

150. M&A Process, *supra* note 130, at 251-67.

dards of conduct, and the goodwill of their partners. Thus, anything that can be done to reinforce and underscore the parties' cooperative union must hold significant value. From the moment of closing onward, there must occur a momentous shift in behavior and expectations. A formal contracting ritual helps cement this transformation in the minds of the parties.

Ultimately, the ritual of contracting provides social and psychological benefits that endure completely distinct from whether the contract in question is ever enforced (or even enforceable).[151] By taking the parties through a series of somewhat tedious and often costly transitions, contracting as an event or ceremony helps focus their attention on the relationship that lies ahead. Trust, cooperation and goodwill, when genuinely felt, are major deterrents to a contract breach. All are also heightened by a properly enacted ritual of incorporation.

IV. The Dual Nature of Contract law

We have now seen, in Part III, that there exist symbolic and ceremonial reasons for a party to desire to negotiate and enter into a contract, even if she does not anticipate ever enforcing it. The act of negotiating terms helps parties coordinate their expectations, build trust and familiarity, and think through the details of their exchange. The contract itself, even if unlikely to be enforced, provides a tangible reminder of the parties' bond and vouchsafes their status. And above all, the process of generating and executing a contract serves a ritual purpose that marks the end of one relationship and the beginning of another.

All of this is interesting in a descriptive sense, but also has deeper normative implications. Dominant neo-classical contract theory is structured around the goal of enforcing the parties' reasonable expectations, or as Gordon Smith and Brayden King describe it, "mitigating *ex post* opportunism."[152] However, in the broadest sense, such theorizing appears not to take into account situations like that described above, where the parties do not appear to place significant value on the enforceability of their rights.

In Part IV.A, I therefore revisit the scholarship of Ian Macneil and attempt to draw previously overlooked lessons from his models. In Part IV.B, I examine recent scholarship in behavioral economics that parallels the results of Macneil's investigations and supports the ultimate conclusion of this Article—that we live not in a world containing a single, unified contract regime but in a world of multiple regimes that should be recognized and dealt with as such. Finally, in Part IV.C, I begin to explore the implications of this finding with respect to existing contract theory and doctrine. In particular, I conclude that the symbolic and ceremonial as-

151. *See* Suchman, *supra* note 4, at 111 ("Even if transacting parties know relatively little about specific legal doctrines and have no intention of seeking court enforcement, the ceremony of drafting and signing a contract may reenact and reinforce central elements of faith, both about the transaction itself and about the larger social order.").

152. Smith, *supra* note 147, at 1.

pects of contract law help both relational and discrete contractors to invoke the power of social norms to mitigate and resolve their disputes.

A. *Macneil Revisited*

Lurking behind the results of our investigation into the symbolic and ceremonial aspects of contracting is the observation that such benefits do not accrue equally to all contracts or all contractors. In a discrete exchange for example, especially where the negotiation and structuring of the deal are completed relatively quickly and easily, as is the case in most commercial exchanges, there may be little value to ceremony. And when the lemon effect is absent or the parties' relationship is comparatively short-lived, symbolism and signaling recede in importance. Indeed, this is exactly the beauty and power of neoclassical contract law; it allows anonymous individuals to engage in exchange without the need to enter into the costly social dance that is typically required to generate relational affiliations.

What we find, then, is that the lesser the degree of relationality inherent in the parties' dealings, the lesser the value of contract law's symbolic and ceremonial functions. And the corollary also appears to be true. When the exchange is highly relational, there is often little need for the parties to resort to litigation to resolve their disputes. Either the disputes can be resolved through extra-legal means, such as those described by Bernstein and Ellickson, or the value of the ongoing relationship is such that the parties are likely to forgive most breaches. As a result, for relational contractors, the insurance function of contracting retreats to the background and imagery and ritual take center stage.

But what meaning does this observation hold for contract law theory and doctrine? For that, we must return to the work of Ian Macneil and his fellow travelers. Surprisingly, despite the widespread acceptance of Macneil's work, it has generated few novel theoretical insights.[153] The legal academy seems to agree generally that some contracts are more discrete and others more relational, and also that context matters when seeking to understand contractual dealings. However, these ideas appear to have been met with something of a shrug from theorists. Macneil's thinking doesn't challenge neoclassical contract theory so much as add to its descriptive power. Here, in the ceremonial and symbolic role of contracts, we may be able to shed new light on his work.

One argument that Macneil makes repeatedly throughout his papers is that *all* contracts are relational contracts. Were it otherwise, with some discrete exchanges existing truly apart from any prior or subsequent obligations, then theft would predominate as being more efficient than negoti-

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153. Jay M. Feinman, *Relational Contract Theory in Context*, 94 Nw. U. L. Rev. 737, 737 (2000) (noting that "while Macneil's work is widely cited, the level of engagement with its details has not been commensurate with its contribution . . . ."); *But see generally Relational Contract Theory: Unanswered Questions, A Symposium in Honor of Ian R. Macneil*, 94 Nw. U. L. Rev. 775 (2000).

ation or compromise.[154] Macneil makes this point in order to highlight the relational nature of much commerce while at the same time holding strong to his ideal of a universal theory that encompasses all legal agreements.[155]

If one is willing to jettison the goal of a single, universal theory, however, one can draw a very different insight from Macneil's conclusions. Indeed, there appears to exist a gap in our understanding of legal and non-legal bargaining. Realist scholars like Bernstein and Ellickson chose as their subject matter economic sectors wherein the parties elected to opt out of the legal system altogether and instead resort to their own private mechanisms of enforcement. For Macneil, meanwhile, his subject matter was contracts that overlap with relationships. None of the three, however, took Macneil's continuum to its logical conclusion and the point that connects their work. Once one proceeds far enough toward the relational end of the spectrum, one appears to depart from the neoclassical world of contract law and enter instead into the non-legal world of Bernstein and Ellickson. Macneil was wrong, in other words, when he declared that the ends of his spectrum, "like the ends of rainbows," don't exist.[156] The relational end *does* exist as a world where the ceremonial and symbolic functions of contract serve to establish and reinforce non-legal norms while traditional notions of contract recede into irrelevance.

Viewed in this light, it becomes apparent that contract law can and should serve multiple functions with different goals predominating at different ends of Macneil's spectrum. On the non-relational end, where parties are at least initially anonymous and transactions comparatively discrete, the traditional role of contract law as guarantor of expectations remains paramount. Contract law enables our modern exchange-based economy by reducing the risks associated with informational costs. By contrast, on the relational end of the spectrum, enforcement recedes in importance as private norms and the discipline of reputational markets

154. *See, e.g.,* Ian R. Macneil, *Economic Analysis of Contractual Relations: Its Shortfalls and the Need for a "Rich Classificatory Apparatus",* 75 Nw. U. L. Rev. 1018, 1040 (1981) ("*All* transactions deserving economic analysis, even the most discrete, take place in the context of *some* social setting which creates relations between the parties. Not even the theoretically discrete transaction of neoclassical analysis can avoid an assumption of some relations preventing the parties from stealing instead of exchanging as well as some relations making promissory words binding.").

155. Macneil, *supra* note 15, at 344 (noting that "it is important to stress the highly relational character of *all* contracts in real life."). Macneil makes this point both in order to argue against the dominance of neoclassical theories of contract and to suggest that it is possible to explain all contractual behavior through the lens of a single, universalist theory of relational contracts. Thus, it is in his interest not only to describe discrete transactions as rare or primitive ("Hobbesian"), but also to stress the universally relational nature of both discrete and non-discrete contracts. *See, e.g.*, Ian R. Macneil, *Relational Contract: What We Do and Do Not Know*, 1985 Wis. L. Rev. 483, 485-87 (1985).

156. Macneil, *Relational Contract Theory, supra* note 12, at 896.

take the fore.[157] As a result, the symbolic and ceremonial value associated with the process of contracting becomes more salient.

This insight suggests that scholars and policymakers should unshackle themselves from the desire to present a single, unified contract theory. Instead, we can better serve market participants by viewing contract law the way that Macneil views contracts—as a spectrum addressing the needs of discrete, anonymous exchanges at one end and of socially intertwined affiliations at the other. Contract law, in other words, should best be understood as having a dual nature. And turning to the complementary field of behavioral economics, this is exactly what we encounter.

B. *Social Markets v. Monetary Markets*

In 2004, behavioral economists James Heyman and Dan Ariely published a paper arguing that there exist two types of markets—social and monetary.[158] Of course, generations of legal realists have understood that social norms can reinforce or even substitute for the power of legal sanction. Even law and economics scholars have largely come around to the view that social context contributes significantly to commercial behavior.[159] But Heyman and Ariely were making a more subtle point.

To make their case, Heyman and Ariely conducted a series of experiments that tested the subjects' willingness to engage in work based on the promise of varying degrees and types of compensation. In the first, they asked participants to predict whether their peers would assist in lifting a sofa into the back of a moving van (to first test the subjects' intuitions regarding their own behavior). In the second, they asked participants to move a series of computer-generated images across a screen for a three-minute period. In the third, they asked participants to spend as much time as they deemed appropriate solving twelve math puzzles, the last of which had no possible answer.[160]

In each of the three experiments, the results were the same. When money was discussed, participants' effort increased and decreased in lock-

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157. Perhaps the best example of this idea is the general partnership. While the subject of a discrete body of statutory and common law, partnerships, like other business entities, are really just semi-permanent bundles of contractual relationships. Indeed, Macneil himself acknowledged the "nexus of contracts" nature of firms. *See* Ian R. Macneil, *Contracts: Adjustment of Long-Term Economic Relations Under Classical, Neoclassical, and Relational Contract Law*, 72 Nw. U. L. Rev. 854, 865 (1978) ("Were we to push far in the direction of contractual relations, we would come to the firm itself, since a firm is, in significant ways, nothing more than a very complex bundle of contractual relations.") (footnote omitted).

158. James Heyman & Dan Ariely, *Effort for Payment: A Tale of Two Markets*, 15 Psych. Sci. 787 (2004).

159. *See generally* Robert C. Ellickson, *Law and Economics Discovers Social Norms*, 27 J. Legal Stud. 537 (1998) (noting that "scholars in many disciplines increasingly are emphasizing the significance of the informal glue that holds a society together.").

160. Heyman & Ariely, *supra* note 158, at 788-92.

step as did the amount of the consideration.[161] Subjects appeared to gauge their level of effort based on the stated value of the promised reward. By contrast, when no money was mentioned, subjects worked at a consistently higher level than when they were offered *any* form of monetary payment.[162] When lifting a sofa or solving math problems became a courtesy rather than a business proposition, they expended maximum effort.

Based on these experiments, and building on prior work in the field of social psychology, Heyman and Ariely posited that human beings inhabit two distinct but overlapping worlds—one characterized by monetary markets and one by social markets.[163] The result, they observed, is that as citizens of two worlds we must all make repeated and frequent (and generally unconscious) decisions regarding which market is dominant during any given interaction, social or monetary. And once the decision is made, we behave according to the dictates of social norms or marketplace competition, as the case may be.

Considering these experiments in the light of Macneil's work on relational contracts, a clear analogy presents itself. We can liken Heyman and Ariely's social markets to Macneil's relational contracts, and their monetary markets to his understanding of discrete exchanges. Heyman and Ariely appear to be observing, through the means of controlled experimentation, the same phenomenon as did Macneil. Our world of commerce is not unified and consistent, but divided and at tension with itself.

C. *Implications for Theory and Doctrine*

For more than a generation, physicists have been preoccupied with the goal of uncovering a "theory of everything." Their aim has been to reconcile quantum mechanics, which explains the behavior of very small things like atoms and their component parts, with Einstein's and Newton's theories regarding gravity, which explain the behavior of very large things like planets and stars.[164] Their assumption has been that it is implausible to imagine that the physical world operates according to two sets of rules. Rather, all things, large and small, must obey the same basic principles.

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161. This was true whether money was mentioned as the form of payment itself or as the value of some non-monetary form of payment, as in "I'll give you a five-dollar candy bar." *Id*.

162. *Id.* at 792.

163. *See* Alan Page Fiske, *The Four Elementary Forms of Sociality: Framework for a Unified Theory of Social Relations*, 99 PSYCHOL. REV. 689, 690 (1992) (arguing that all social interactions can be divided into one or more of four categories: communal sharing, authority ranking, equality matching, and market pricing). *See also* Margaret S. Clark & Judson Mills, *Interpersonal Attraction in Exchange and Communal Relationships*, 37 J. PERSONALITY & SOC. PSYCHOL. 12-24 (1979); Margaret S. Clark, *Record Keeping in Two Types of Relationships*, 47 J. PERSONALITY & SOC. PSYCHOL. 549-57 (1984).

164. *See generally* LEE SMOLIN, THE TROUBLE WITH PHYSICS: THE RISE OF STRING THEORY, THE FALL OF A SCIENCE, AND WHAT COMES NEXT (2006) (arguing that theoretical physicists have become overly enamored of elegance and simplicity).

Except that, despite the efforts of countless scientists and mathematicians, no one has yet uncovered any of those principles.[165]

Universalists like Macneil (and for that matter, the drafters of the Restatement and the Uniform Commercial Code) have fallen into the same trap. Generally speaking, they assume that "contracts" represents a single, coherent doctrine capable of explaining and policing all commercial behavior.[166] And yet where is the offer and acceptance in a complex, months-long merger negotiation? And can the same theory of consideration provide an adequate explanation for the enforceability of marriage proposals and shrink-wrapped computer licenses? Surely, the goals of contract law with respect to online user agreements need not be identical to those applied to a social institution like marriage.

The work of behavioral economists in distinguishing social and monetary markets, the continuum of relationality described by Macneil, and the value that private investment fund managers and investors appear to place on the symbolic and ceremonial aspects of contracting—all of these point away from a single, universal theory of everything for contract law. Instead, they suggest that contract law contains within itself a duality of both purpose and function.

Macneil's continuum, once separated from its universalist tendencies, establishes a theoretical foundation for such a division of doctrine. When exchanges are discrete and involve comparatively anonymous participants, contract doctrine reduces transaction costs by guaranteeing that the parties' reasonable expectations will be met. By contrast, when transactions are ongoing, frequent, and involve close personal contact—when they are "relational" or "social"—the purpose and function of contract law shift. The benefits to be derived from ceremony and symbolism rise to paramount importance. Indeed, the UCC already takes tentative steps in the direction of duality when it distinguishes between merchant and non-merchant transactions.[167]

This recognition of contract law's dual nature yields two primary implications, the second being significantly more subtle and profound than the first. In the first place, it suggests that contract doctrine should be tailored to respond to the particular function or functions that are most relevant to the particular context of any given transaction. When an exchange is discrete and the parties are economic strangers, the law should seek to maximize its role as marketplace policeman, for example by emphasizing the use of bright-line rules. By contrast, when the context is more relational

165. Although string theory has been recommended as a possible solution with the potential to explain the behavior of both large and small objects, it has been criticized for both failing to predict new phenomena and being unverifiable in that it cannot be disproved through scientific inquiry. *See generally id.*

166. *See* Macneil, *supra* note 15, at 344.

167. *See, e.g.,* Uniform Commercial Code § 2-314 (2004) (stipulating that "a warranty that the goods shall be merchantable is implied in a contract for their sale *if the seller is a merchant* with respect to goods of that kind.") (emphasis added).

or social in nature, doctrine should be evolved to serve the parties' symbolic and ceremonial interests.[168] The law's role, in other words, should adjust as the parties' needs change.

But merely seeking to marry doctrine to the context of a deal is far too unambitious a goal for such a potent legal regime as contracts. If Heyman and Ariely are correct, the law can be used not only to respond to and reflect the parties' pre-existing interests and goals, but to help shape and alter those interests and goals. Extrapolating from the current behavioral economics research, we can infer that the degree of a transaction's relationality is to some extent malleable. As Heyman and Ariely put it, the range of a person's "prosocial" behavior can be impacted by various external cues and stimuli.[169] And here we find the second and more important implication of a non-unitary theory of contract law. Wherever possible, contract doctrine can and should be designed so as to push or "nudge" entire transactions into the world of social markets described by Heyman and Ariely.[170] In this respect, symbolism and ceremony morph to become simultaneously both means and ends.

To date, most of the behavioral economics research into social and monetary markets has been focused on the impact of money on the parties' behavior, with the mere mention of dollars tending to thrust the parties' relationship toward the monetary end of the spectrum.[171] Consider, for example, a well-known study of childcare centers in Israel. Its authors, Uri Gneezy and Aldo Rustichini, noted that parents sometimes arrived late to pick up their children. When the parents were informed that they would henceforth be subjected to a monetary fine each time they arrived late, however, the occurrence of lateness markedly *increased* rather than decreased.[172] Forcing the caregivers to stay late after work hours ceased to be perceived as impolite behavior for which the perpetrators would have to pay a social price, and became a service that they could purchase

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168. *See* Macneil, *supra* note 157, at 854 (noting that relational contracts require greater amounts of flexibility and are therefore better suited to broad standards).

169. *See, e.g.,* Dan Ariely, Anat Bracha & Stephan Meier, *Doing Good or Doing Well? Image Motivation and Monetary Incentives in Behaving Prosocially*, at 2-3, 17-18 (2008), *available at* http://opimweb.wharton.upenn.edu/documents/seminars/Meier_Paper.pdf. Note, however, that existing research suggests that cues for monetary norms are extremely powerful and not easily overcome by other signals or behaviors. *See, e.g.,* Uzi Gneezy & Aldo Rustichini, *Pay Enough or Don't Pay at All*, 115 Q. J. ECON. 791, 791-93 (2006); Samuel Bowles & Sandra Polania Reyes, *Economic Incentives and Social Preferences: A Preference-based Lucas Critique of Public Policy*, CESifo Working Paper No. 2734, at 19-21 (2009), *available at* http://www.cesifo-group.de/pls/guestci/download/CESifo%20Working%20Papers%202009/CESifo%20Working%20Papers%20July%202009/cesifo1_wp2734.pdf.

170. *See* RICHARD H. THALER & CASS R. SUNSTEIN, NUDGE: IMPROVING DECISIONS ABOUT HEALTH, WEALTH, AND HAPPINESS 14-15 (2008) (describing how legal doctrine can be utilized to push people toward particular policy ends without unduly limiting their freedom to choose otherwise).

171. *See, e.g.,* Kathleen D. Vohs, Nicole L. Mead & Miranda R. Goode, *The Psychological Consequences of Money*, 314 SCIENCE 1154 (2006).

172. Uri Gneezy & Aldo Rustichini, *A Fine is a Price*, 27 J. LEGAL STUD. 1, 5-8 (2000).

with money. The application of an external cue—in this case a monetary fine for arriving late—changed the parties' behavior from a cooperative, nonmarket activity into a purely economic exchange.[173]

As a corollary to the work done on the impact of monetary cues, there is reason to postulate that the opposite result can also be achieved. By controlling various external factors, including the quality and quantity of symbolism and ceremony that accompany a transaction, both lawmakers and market participants appear to have the power to prod a given transaction toward the realm of social markets. When the parties to a contract consciously summon up social norms intended to accentuate the relational aspects of the transaction, they will tend to be rewarded by more cooperative and altruistic behavior on the part of their counterparties. Imagery and ritual can thus potentially recast a discrete or monetary transaction in terms of social norms and thereby introduce an entire other, non-legal paradigm of protection for the parties.[174]

In this respect, symbolism and ceremony are of both direct and indirect value. As we have seen, relational market participants are benefitted by both the imprimatur that a properly crafted contract can impart and the ritual consequences that arise from the process of contracting. In addition, however, these cultural aspects of contract law also provide indirect value as a means to elicit and strengthen social norms. By highlighting the relational nature of a transaction, imagery and ritual provide external cues that frame the parties' interaction in terms of Heyman and Ariely's social markets. They encourage the parties to imagine themselves occupying a world governed not by legal dictates but by norms of good behavior.

Law and sociology scholar Mark Suchman (among others) argues that legal doctrine and judicial dispute resolution are of relatively little importance when compared to informal community norms.[175] Resort to litigation can be costly and risky, and tends to put an end to any prior relationship. Norms, by contrast, have the power to resolve the many minor disputes and misunderstandings that are inevitable in any ongoing relationship. As such, they serve as the ultimate gap-filler, addressing matters too granular for our blunt legal system to manage. A legal regime that uses symbolism and ceremony to increase the prevalence and power of such norms therefore promises to be extremely potent.

Admittedly, the audience for this type of theorizing may not be lawmakers and judges so much as attorneys and counselors. If parties to a contract wish to make its signing or closing into a spectacle of pageantry, existing doctrine will not impede them. It is within the power and discre-

173. *Id.* at 13.

174. This observation is essentially a variation on Macneil's (and others') pronouncement that, in general, contract law should and does "more or less track" the behavioral norms of contracting parties. *See* Macneil, *Relational Contract Theory*, *supra* note 12, at 893.

175. Suchman, *supra* note 4, at 96 ("Legal doctrine and legal recourse often matter very little . . . since most transactions are governed, in practice, by informal community norms, enforced by informal social sanctions.").

tion of the attorneys advising on the transaction to create such a result. Indeed, deal lawyers have long recognized the importance of addressing social issues when negotiating a transaction.[176]

Still, while existing law accommodates the use of symbolism and ceremony, it neither requires nor encourages it. Evolving a set of doctrines that seek to enhance their impact will not only serve the direct interests of relational contracts but also shift all contracts toward the relational or social end of the spectrum and thereby fortify the impact of social norms in setting modes of behavior and resolving disputes informally.

Bernstein, meanwhile, warns that attempting to incorporate community norms into judicial decision-making can disrupt the informal functioning of those very norms.[177] But that is not my claim. My claim is that the law should seek to identify and promote not the norms themselves, but the factors that make norms arise and predominate in the first place. Private law should seek to bolster those factors that help frame a transaction as being more social or relational, thereby encouraging and reinforcing both greater reliance on norms and increased usage of contract's symbolic and ceremonial functions.

Ultimately, the goal of contract law should be to make itself irrelevant in all but the most discrete of private transactions. Contract law is, after all, only a second-best solution. If the parties in fact cooperate and trust one another, any compromise they achieve will be in nearly all respects superior to the law's formal mechanism of *ex post* dispute resolution. Given the power of social norms to avoid, minimize, and ultimately resolve disputes via extra-legal mechanisms, we should therefore seek to make all transactions as relational as possible. Legal doctrines that emphasize ritual and imagery provide external cues that frame interactions as occurring within the realm of social markets and so underscore and heighten the impact of social norms.

V. Conclusion

Most contracts are never breached. And most breaches, whether real or anticipatory, are never litigated. Rather, the vast majority of contract-related behavior takes place within the private realm of the contracting parties' intramural relationship. And yet, as this Article makes clear, there are significant ceremonial and symbolic benefits associated with the *process* of contracting that extend beyond the value of any legal rights an enforceable agreement may generate.

The behavior of private investment funds during the panic of 2008 is a prime example of this. Large numbers of hedge fund managers refused to

176. M&A Process, *supra* note 130, at 66-69; Freund, *supra* note 133, § 11.2.

177. Lisa Bernstein, *Merchant Law in a Merchant Court: Rethinking the Code's Search for Immanent Business Norms*, 144 U. Pa. L. Rev. 1765, 1768-69 (1996) (arguing that attempts by judges to incorporate "immanent business norms" into their decisions, as contemplated by the Uniform Commercial Code, can disrupt and interfere with the vary norms the law seeks to promote).

return their investors' capital, yet their investors largely acquiesced. Similarly, large numbers of investors reneged on their promise to fund future venture capital deals, yet the fund managers again failed to press their rights. The parties valued their contracts enough to expend significant time and resources negotiating them on the front end, but did not care to resort to contract law's ultimate sanction in order to enforce their expectations on the back end.

Generations of scholars have found it fruitful to approach the study of contracts, first from a classical, formalist direction, then from a more context-based neo-classical direction. My tentative conclusion from the case studies presented in this Article is that it may be time to begin approaching contracts from additional directions as well. One possibility is to consider studying contracts more as process than product—more for their ceremonial and symbolic functions than as mere abstract vessels embodying a set of legal rights and obligations. Another related possibility is to begin to consider more assertively the context in which transactions take place, with the goal of tailoring doctrine to the particular needs of particular deal structures. One way to tackle this challenge would be to spend more time comparing the use of contracts across industry segments, historical periods, and cultures.[178] Other disciplines, including anthropology/sociology and behavioral economics, may also provide useful fonts for innovative thinking.

My objective in this Article is not to challenge the usefulness of existing neo-classical contract doctrine to explain and regulate discrete exchanges. Rather, my goal is to counter the universalist tendency of legal (and other) scholars to seek elegant, all-encompassing theories where none exist. Our understanding of both monetary and social markets would be enhanced if we moved beyond the temptation to privilege graceful theories over messy contextual realities. By emphasizing where appropriate the symbolic and ceremonial aspects of a transaction, the law can both serve the direct interests of relational contractors and enhance the external cues that elicit and incorporate potent social norms. Contract law does not lend itself to a theory of everything.

178. *See* Suchman, *supra* note 4, at 125.